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Social Market Foundation

BEVERIDGE REBOOTED

Social security for a networked age

Ian Mulheirn with Jeff Masters

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THE SOCIAL MARKET FOUNDATION

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FOREWORD

The debate about welfare reform – so necessary if we are to ensure our labour markets remain efficient and effective – has for many years been a sterile place where rhetoric rather than evidence has ruled the roost. This is a great pity as this debate is perhaps one of the most important political challenges our society faces. Over a £100 billion a year – 15% of our national wealth - is spent on benefits for working age adults and yet the system is clearly failing. Even though benefit levels in the UK are low in comparison to many other European countries, few people believe that the current system supports a culture of personal responsibility or is fair to those who have worked hard all their lives and then suddenly find themselves in economic hardship through unemployment or disability. In fact there is strong public disquiet today about the whole operation of our benefits system. The Beveridge reforms which laid the foundation for our welfare society enjoyed widespread public support back in the 1940s. Things are very different today. In truth, we lost the plot on welfare some time ago and for many years we have been sliding down a long and slippery slope.

For the main political parties, the debate on welfare reform has become characterised as a simple contest to provide the toughest denunciation of 'work shy scroungers' and 'feckless' single parents. It is absolutely obvious that a fair system of welfare must be able to discriminate between those who need help and those who can help themselves. But it must do more than this. How can it support those people who have paid into the system through higher taxes and national insurance contributions? Fairness cuts both ways.

There is one other problem we need to own up to. New reforms are normally layered upon earlier attempts at improving the way the welfare machine works, making the system even more complicated and impenetrable. The language of reform has certainly increased in tempo with the arrival of the Coalition Government in 2010. The latest set of reforms – with Universal Credit at their heart - certainly looks at

first glance to be at the radical end of the spectrum. Benefits are being simplified. Fresh incentives to work are being introduced. Penalties for infringements are being increased. Brave though these reforms undoubtedly are, the principles behind the new system in many ways resemble the old rules it will sweep away. So, will Universal Credit really bring about the change in culture and behaviour that everyone seeks? I don't think so.

This series of essays from the Social Market Foundation has, in my opinion, provided a degree of clarity on these questions that that few others have succeeded in doing. It is why these essays should be taken seriously by policy makers and all those who pontificate on the future of our welfare society.

At the heart of the Beveridge proposals lay the contributory principle. People would pay in to a system of benefits which would be there when they needed it. Beveridge himself proclaimed the view that a welfare system should provide "benefits in return for contributions, rather than free allowances from the State..." In the current debate, all of the main parties have signalled their support for this fundamental principle. But all have shied away from providing a compelling, modern version of what this might look like.

Building on the introduction of auto enrolment into workplace pensions, the authors of these essays spell out a new way to encourage people, through new Lifecycle Accounts, to invest in their own economic future and hedge against the risk of adverse life events. This is genuine radical thinking. It stresses the role of the individual as opposed to the state. It lays the emphasis on people saving for a rainy day, rather than asking others to do this for them. Both are going to be necessary in my view if we are to return to a concept of sustainable welfare which commands public confidence and support.

So it is not without hard edges. First, it acknowledges that some people will be able to draw on more financial support through any

hard times than those who have not contributed in this way. Our current benefit rules have completely blurred this corner stone of the Beveridge reforms. If people want to support the concept of the contributory principle going forward, it is hard to avoid the conclusion that such an outcome is inevitable. Second, it recognises that this will require additional personal saving to finance the higher benefit levels that go with it.

We urgently need to re-kindle the notion of a savings culture in Britain, not least if we are to manage the process of demographic change in a sensible and fair way. These proposals could be a helpful step in that direction, as well as a way to lock in middle class support for the concept of a welfare society.

The authors also break new ground by outlining an entirely new approach to the incentives problems posed by means-tested benefits. Their proposals for 'Facebook Welfare' draw on the principles behind micro-finance in the developing world to put social connections, rather than anonymous government agencies, at the heart of the benefit system. Their aim to strengthen recipients' sense of obligation to their peers is an intriguing avenue for policymakers to explore, even if the practicalities of it are challenging.

Telling people that they need to save more and actually making this happen through legislative reforms will never be an easy thing for politicians to sign up to. Nor will be actions to make the welfare system harness the potential of social connections. But without candour and honesty in this debate, we are simply destined to go on fudging things. And the price of fudging things could be a high one – the withdrawal of public support for the concept of a welfare society altogether. Given the importance of welfare to the very concept of societal cohesion, this would be a dangerous gamble to take.

Lord (John) Hutton
August 2013

ESSAY 1: FROM THE MAGIC OF AVERAGES TO A CRISIS OF LEGITIMACY

Ian Mulheirn and Jeff Masters

> *"National compulsory insurance will [bring] the magic of averages to the rescue of millions"*
>
> Sir Winston Churchill

INTRODUCTION

How times change. Seventy years ago, the Beveridge Report was launched to popular acclaim. People queued around the block to pick up their copy of the seminal blockbuster. Prime Minister Winston Churchill endorsed Beveridge's plan for unemployment insurance, claiming that it would bring "the magic of averages to the benefit of millions". Welfare was a vote-winner.

In the intervening 70 years, the descent from Beveridge has been total. Public attitudes have hardened towards unemployed people, and the political parties now compete to sound tough on 'scroungers'. In setting out their proposals, today's politicians regularly invoke Beveridge, however tenuously, in a forlorn effort to recreate the optimism of that time. But there is no escaping the fact that today's working age welfare system is politically toxic and the public debate about it has become untethered from evidence or a semblance of rational discussion.

What do we mean by 'welfare'? Working age people will receive 45% of the £209.4bn total welfare bill in 2013–14, with the majority going to people of pension age. Around a quarter of working age spending – including Child Benefit, maternity pay and Disability Living Allowance – is unrelated to the income or labour market status of recipients. And a chunk of the rest goes to people

judged to be unable to work for one reason or another. Decisions about the level of these benefits are primarily a societal choice about how generous we want to be to these groups, rather than economic ones.

The remaining benefits – particularly Housing Benefit and tax credits – are claimed both by workless and low-income working families. The generosity of these and the main unemployment benefit, Jobseeker's Allowance (JSA), is governed as much by economic considerations as public preferences for redistribution. Generally speaking, high levels of support for people who are not in work reduce their incentives to find a job. This affects both recipients and those paying taxes to fund the benefits. And while transfers to other groups may be more socially acceptable, public attitude surveys suggest that unemployed people are the particular focus of opprobrium.

This series of essays – *Beveridge Rebooted* – explores the crisis of legitimacy in working age welfare as it relates to unemployment in particular. For that reason, the focus of the policy discussion is on JSA as the core benefit paid in respect of unemployment. As such, it is the marginal benefit that determines the standard of living (after housing costs) a person or family can expect while unemployed. However, the principles apply to other benefits or tax credits received by unemployed families.

Our aim is to explore the various policy prescriptions for what to do about financial support for the unemployed. Should it be more generous? Should it be less generous? Or should we somehow revive the central plank of Beveridge's 1942 proposals: benefits claimed as a right based on past contribution? These questions are not new. Policy towards the unemployed has been a contentious area since at least the Elizabethan poor laws of the sixteenth century. But today we know far more about how to create a system

that supports people while providing appropriate incentives for work, and we have new technologies to achieve those aims. In four essays, *Beveridge Rebooted* decomposes the policy challenge and the usual prescriptions, and concludes by proposing a system of financial support for the unemployed that would be both fairer and more economically efficient than the regime we have today.

This first essay looks at the reasons for the descent from the optimism of Beveridge to the problems facing the welfare system today. We explore the welfare paradox: unemployment benefits in the UK are among the most meagre in the developed world and yet public attitude surveys consistently show widespread and growing concern that they are overgenerous to the unemployed. Understanding how we came to be in this situation is the first step in finding a better solution.

Essay two sets out the orthodox approach that has governed unemployment policy for the past 30 years under governments of all hues. We show that the simple characterisation of unemployment benefits as socially necessary but economically harmful represents a misunderstanding of how the labour market works. For workers with skills and experience, a diet of meagre benefits and tough sanctions is damaging the productivity of the UK workforce.

In the third part of *Beveridge Rebooted*, we turn to the idea of reviving contributory unemployment insurance, an increasingly popular idea being considered by people in both the Labour and Conservative parties. Drawing on international comparison and historical analysis, we identify the challenges and shortcomings of collective contributory unemployment insurance.

In the final essay, drawing on all of the foregoing analysis, we propose an entirely new approach to unemployment policy. We identify a two-part solution that can minimise the incentive problems that justify the current, ungenerous, levels of support. In doing so we outline the possibility of a new system of unemployment insurance that increases personal freedom, offers more generous entitlements, encourages human capital development and also supports the efficient operation of the labour market.

THE PARADOX OF WELFARE

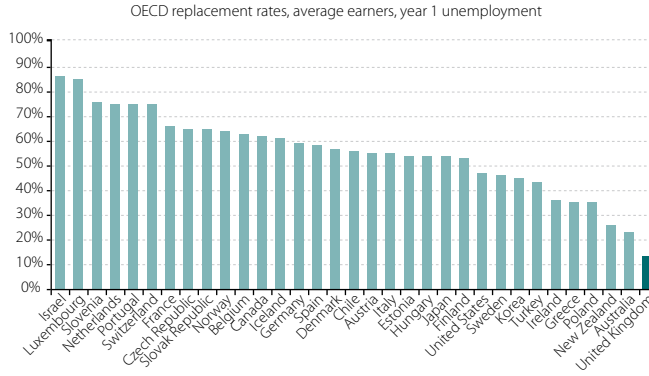
Published in 1942 with the country at war, the blueprint for the welfare system – Beveridge's report on Social Insurance and Allied Services – was a popular success. Long and dense, it became an implausible best seller with some 635,000 copies ultimately sold. The sense of popular enthusiasm for the Beveridge's proposals for unemployment insurance – offering benefits as a right, rather than as the result of the hated means-test – was palpable.

Seventy years on, this is now ancient history. The early hunger for a comprehensive, inclusive system of social security has been replaced with weary cynicism. A paradox has emerged about working age welfare: it is simultaneously meagre for beneficiaries and unpopular among those who pay for it. Never pure, the logic on which the system was founded in 1948 has become contorted and distorted by decades of reforms. As a result it has become politically and economically unstable, and increasingly viewed as unfair. Created to slay the giant of idleness it is now viewed by many as rewarding it. Intended to encourage self-reliance, it is now seen as undermining it. Designed to offer households protection from economic and social risks, it no longer speaks to many of the challenges of modern life. Faced with immediate and longer-term fiscal pressures, our system of working age welfare has come to be viewed not as part of the solution but as a major part of the

problem: a cost that must be minimised, and an obstacle to the growth we need. A closer examination of the facts illustrates the nature of the paradox of welfare.

At just £71.70 per week for a single adult, the main unemployment benefit, Jobseeker's Allowance (JSA) is minimal. Although other benefits, including Housing Benefit and Child Tax Credits, are available to some unemployed people to meet specific costs, state protection against loss of income for working adults due to unemployment is among the most limited in the world. Chart 1.1 illustrates how, on becoming unemployed, a single childless person on average earnings in the UK receives the lowest income replacement level of anywhere in the OECD.

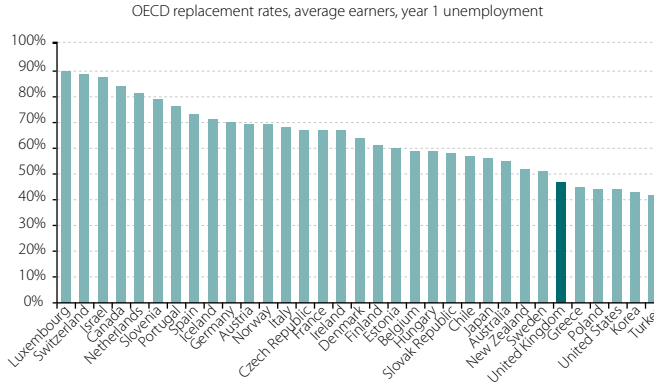
Chart 1.1: Benefit generosity for single childless people



Source: OECD
Note: Net replacement rates as a percentage of previous income for a family on average earnings during first years of unemployment, excluding housing or other social assistance top-ups, 2011.

For an average earning couple with children, the picture is little better (see Chart 1.2). This reflects the reality of a highly a needs-based welfare system, with little support given to anyone on the basis of past contribution. Yet even when means-tested top-ups are included, the UK's replacement rates for families on average earnings are typically well below the OECD average.

Chart 1.2: Benefit generosity for couples with children



Source: OECD

Net replacement rates as a percentage of previous income for a family on average earnings during first years of unemployment, excluding housing or other social assistance top-ups, 2011.

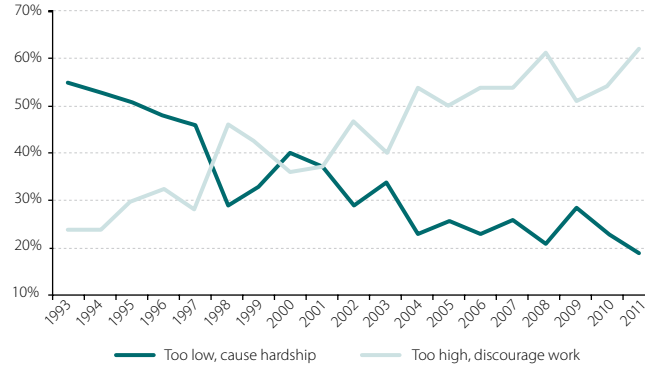
So unemployment protection in the UK is ungenerous. And yet, over the past 20 years public support for our system of working age welfare has markedly declined. The long-running British Social Attitudes Survey has documented the trends. Fully 62% of people now think that 'benefit payments are too high and discourage work', up from only 27% in 1991. In 2001, 88% of the British public agreed with the statement that government should be mainly responsible for ensuring that people have enough to live on if they become unemployed. By 2011, this had fallen to 59%. This change in public attitudes contrasts sharply with the relative stability of support for other government responsibilities over the same period. For example, the percentage viewing government as having the main responsibility for meeting the cost of healthcare or the living costs of the long term sick and disabled have both remained around the mid-80s.[1]

It also contrasts with the experience of previous recessions, which have typically seen sympathy for the unemployed increase as unemployment increased. Chart 1.3 suggests that the trend

1 A. Park, E. Clery, J.Curtice, M. Phillips and D. Utting (eds.) British Social Attitudes: the 29th Report, (London: NatCen Social Research, 2012), 5. Table 1.1.

to hardening attitudes has continued despite unemployment remaining high since 2009.

Chart 1.3: Social attitudes towards unemployment benefits



Source: British Social Attitudes, 29

Over the last decade, there has also been a growing fear that the welfare system is undermining self-reliance. In 2001, only 39% of people thought that lower benefits would encourage people to 'stand on their own feet', compared with 54% a decade later. With this has come a smaller increase in the proportion who think that the welfare state discourages people from helping one another, up by more than one sixth from 28% in 2001 to 33% by 2011.[2]

As a result the system is failing politically: social security is electorally toxic, with the only apparently safe political stance to talk ever tougher about 'tightening up' the system. There are differences in attitudes to welfare across supporters of political parties, but a majority of supporters of each of the three main parties have a negative view of unemployment benefits.

Conservative voters are most likely (77%) to believe that the level of unemployment benefits is discouraging work, compared

2 Ibid., 25. Table A.5.

with 55% among Labour and Liberal Democrat voters. The trend in attitudes is even more intriguing. While starting from different bases, there has been a hardening of attitudes among supporters of all parties. Since 2003, the proportion of survey respondents concerned about the effect of unemployment benefits on work incentives have increased by around 20 percentage points among voters from each of the three main parties. For Labour and Liberal Democrat voters, most of this change in views occurred between 2003 and 2007 when the economy was buoyant. Among Conservative voters, views have hardened by 10 percentage points since 2007, during tougher economic times.[3]

This antipathy comes despite the fact that the main social security benefit for unemployed people – Jobseekers Allowance (JSA) – is no higher in real terms than its predecessor, Unemployment Benefit, back in the early 1970s, and starting to fall. Relative to average incomes and consumption, which have roughly doubled over that period, JSA has declined substantially.[4]

Whatever the reasons that negative perceptions have taken root, they have hardened into stark political facts. It is therefore unsurprising that barely a month goes by without a politician of some persuasion denouncing the 'something for nothing' deal that our welfare system supposedly offers.

There is plenty of room for argument over whether political rhetoric shapes or reflects public attitudes to welfare. Tracking the changing views of voters, John Curtice claims that in the 1990s and early 2000s Labour voters were following the direction set by

3 Ibid., 16. Table 1.6. For Conservative voters, the proportion agreeing with the statement that unemployment benefits are too high and discourage work has risen by 21 percentage points, from 56% to 77%; among Labour voters the increase is 19 percentage points ((36% to 55%); and among Liberal Democrat voters the increase is 20 percentage points (36% to 55% – difference due to rounding).

4 Peter Kenway, *Should adult benefit for unemployment now be raised?* (York: Joseph Rowntree Foundation, 2009), 12.

the party leadership as their views drifted rightward.[5] Others have identified a close association between negative media coverage about benefit claimants and public attitudes.[6] But one is bound to ask what is driving the negative rhetoric and coverage, and why tough attitudes to welfare seem to sell both policies and papers.

Much of the debate turns on the perception that large numbers of recipients of unemployment benefits are perpetually or frequently on benefits. But new evidence suggests otherwise. Department for Work and Pensions analysis has examined a sample of JSA recipients aged 32 to 34, who made a claim in 2010–11, and looked at their recent benefit histories over the previous four years. In the sample, 40 per cent of adult claimants had no recent history of claiming unemployment benefits. Sixty-three per cent had spent no more than six months of the previous four years on JSA. And 76 per cent of claimants had spent at least three-quarters of the past four years off the dole. Only a small minority of these adults – 11 per cent of the sample – had a history of spending more than half of recent years on the dole, cycling in and out of employment.[7]

This implies that, overwhelmingly, most people who claim JSA each year spend the vast majority of their time in work. Crucially, for 40 per cent of claimants each year, the need to claim JSA is an aberration in an otherwise unbroken recent employment history. This stands in stark contrast to the common perception of widespread unemployment benefit dependency. Despite these people's past tax and National Insurance contributions, today's welfare system gives them very little support.

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5 J. Curtice, "Thermostat or weathervane? Public reactions to spending and redistribution under New Labour", in *British Social Attitudes: the 26th Report*, eds. A. Park, J. Curtice, K.Thompson, M.Phillips, E. Clery, and S.Butt (London: NatCen Social Research, 2010).

6 B. Baumberg, K. Bell, D. Gaffney, R. Deacon, C. Hood and D. Sage, *Benefits Stigma in Britain* (London: Turn2us, 2012).

7 Department for Work and Pensions, *JSA benefit history and benefit receipt* (London: HMSO, 2013), http://statistics.dwp.gov.uk/asd/asd1/adhoc_analysis/2013/ad_hoc_jsahistory_final.pdf.

So popular anger about what is in fact a small minority of claimants is not helped by experience of those who have played by the rules and paid into the system over many years. As the above evidence indicates, every year, hundreds of thousands of people with strong work histories experience unemployment and claim JSA. Compared to a generation ago, they now find that eligibility criteria have tightened, the length of time they can claim has been shortened, and the value of the unemployment benefits has fallen substantially over time, despite their having paid into the system. Bell and Gaffney have labeled this a 'nothing for something' system, nicely capturing the reality for many who receive a relatively low level of entitlement (next to nothing), despite having made substantial contributions into the system for many years (for something).[8]

These twin perceptions – of a system that can be simultaneously understood as offering 'something for nothing' to some and 'nothing for something' to others – explain why our social security system is in crisis. They explain why our unemployment system neither inspires confidence among taxpayers, nor provides effective support for those who need it. It is increasingly seen to be over-generous, economically damaging, and out of control. Yet, paradoxically, it provides some of the least generous support available in the developed world for people who have contributed and experience the misfortune of unemployment.

The on-going repairs to the public finances, requiring deep cuts to public spending that are now likely to run until 2017–18, has brought the crisis of legitimacy to a head as tough spending decisions have to be made. But this is a problem with much deeper roots. How is it that we have arrived at the current crisis of legitimacy? Understanding how the problem has unfolded over

8 Kate Bell, Declan Gaffney, "Making a contribution: social security for the future", Touchstone Pamphlet Number 12 (London: TUC, 2012).

recent decades provides the best opportunity for finding a solution that works more effectively in the future.

In the rest of this essay we consider the important long term causes of today's problem of legitimacy for working age welfare and benefits for the unemployed in particular. First, the challenge from within: the fundamental instability of the system that resulted from Beveridge's original design and subsequent reforms. Second, the challenge from without: the changing nature, incidence and consequences of social and economic risks.

1. THE CHALLENGE FROM WITHIN: SYSTEM INSTABILITY

The basic outlines of our system of working age welfare were set in the late 1940s, based on the recommendations of Beveridge's landmark 1942 report, Social Insurance and Allied Services:[9]

> *"The main feature of the Plan for Social Security is a scheme of social insurance against interruption and destruction of earning power and for special expenditure arising at birth, marriage or death. The scheme embodies six fundamental principles; flat rate of contribution; unification of administrative responsibility; adequacy of benefit; comprehensiveness; and classification. Based on them and in combination with national assistance and voluntary insurance as subsidiary methods, the aim of the Plan for Social Security is to make want under any circumstances unnecessary."*[10]

Beveridge's plan for social security was just one element of his comprehensive plan to slay not just the giant of Want, but also of Disease through a National Health Service; Squalor through a national housebuilding programme; Ignorance through reforms to education;

9 In fact, the reforms introduced in the wake of the Beveridge Report built on many aspects of the pre-existing system.

10 William Beveridge, *Social Security and Allied Services*, (London: 1942), paragraph 17.

and Idleness through an underlying commitment to full employment, tying social and economic objectives together. Much of this plan was implemented, but the social security scheme that came into effect in 1948 contained several important differences from the original blueprint that have had lasting consequences for both the economics and politics of working age welfare policy ever since.

Beveridge was determined that his scheme for national insurance would be internally consistent, and externally acceptable. Internally, entitlement would be triggered by "interruption and destruction of earning power" and based on previous contribution. Externally, it would place no additional burden on taxpayers because it would be self-funded from contributions. While participation in the scheme was mandatory, contribution would be rewarded: entitlements would be a matter of right, freeing contributors from the stigma of means testing; and, crucially, insurance benefits would be paid at a higher level than means tested support. This would, in Beveridge's view, accord with the sensibilities of the British public:

> *"Benefit in return for contributions, rather than free allowances from the State, is what the people of Britain desire..."*[11]

Under Beveridge's design, all workers would make the same flat rate payment into the scheme:

> *"Payment of a substantial part of the cost of benefits as a contribution irrespective of the means of the contributor is the firm basis of a claim to benefit irrespective of means".*[12]

Anyone needing to claim would be entitled to the same flat rate, subsistence payment, regardless of their income. This payment was to be set at a 'subsistence level' – adequate, but not

11 Ibid., paragraph 21.

12 Ibid., paragraph 21.

more than adequate – for two reasons: first, it would allow a family to meet the costs of living without having to rely on other, means tested, support; and second, so as not to discourage households from making additional provision. These features of the design were the essence of the proposal: a single flat rate premium paid by all, meeting the costs of and creating entitlement to a single flat payment set at a level just adequate to meet the costs of living. Beveridge also saw this scheme as sufficient to meet the costs of a basic pension in retirement, if phased in over a 20 year period to allow sufficient reserves to be built up. It was intended be a funded system, rather than one reliant on current income to pay current entitlements. A separate, less favourable scheme of tax-funded National Assistance would meet the needs of those outside the insurance scheme, along with a system of family allowances to meet the additional costs of children.

The focus on inclusiveness through flat rate contributions and flat entitlements was what made Beveridge's scheme distinctive. In particular it can be contrasted with the Bismarckian insurance schemes in much of continental Europe, where both contributions and entitlements were and are based on an individual's prior earnings. There were fundamental contradictions in Beveridge's aims for his scheme.[13] But at its core it was similar to the Bismarckian model in the important sense that it was not designed to be particularly redistributive. It was very much intended to be an insurance scheme that would indeed bring the "magic of averages" to the help of working people. Any redistribution that might occur would result only from the greater likelihood of some workers experiencing interruptions in their earnings, or from some workers living longer than others and therefore claiming retirement pensions for longer.

13 H. Glennerster and M. Evans, "Beveridge and his Assumptive Worlds: The incompatibilities of a Flawed Design" in *Beveridge and social security: an international retrospective*, eds. John Hills, John Ditch and Howard Glennerster (Oxford: Clarendon Press, 1994), 58.

But Beveridge's plan was vulnerable both to the flaws in its own design, and to future reforms that would undermine it further.

Some of the seeds of the current problems were laid in the blueprint itself. The fact that Beveridge wanted his system to be a minimal base upon which people should be encouraged to make private provision left the project vulnerable to the polarisation of risk and life chances over the subsequent 70 years. This would drive the residualisation of the system over time (see below), as the meagre level of support rendered the system irrelevant to the better-off. By contrast, Bismarkian systems, which sought to link entitlements to prior earnings, have proven more resilient. We explore this in more detail in a subsequent essay.

There were also other weaknesses of Beveridge's original design that came to be revealed in time. Housing costs, for example, were excluded in his calculation of subsistence needs. This meant that for families living in areas where housing costs were higher, payments received by right through National Insurance did not meet their costs of living, making them automatically dependent on additional, means tested payments. Over time, as the relative cost of housing rose, this problem became substantially worse.

More important in understanding how we arrived at the current crisis of legitimacy are the ways in which the scheme was implemented and subsequently reformed. This differed markedly from what Beveridge had proposed. Two aspects of the difference between Beveridge's proposals and the policy that was enacted were crucial.

The first was the choice of financing. In Beveridge's plan pensions were to be phased in over two decades to allow a funded pensions system to build over time. Instead, the full entitlement was introduced from day one, paid for by current contributions – known as a 'pay as you go' system. This undermined a key source of

stability for the system by tying it to the tax system. While ambiguity about the status of insurance benefits remained for a decade, in 1959 the Conservative government implemented proposals that formally broke with Beveridge's aspiration for a funded scheme.[14] Current contributors would henceforth explicitly finance current claimants – of both working age and pension benefits – rather than current contributors financing their own future claims.

As a result, loyalty to the idea of the social security system could only rest upon a theoretical promise by government to continue to pay, rather than the reality of an accrued fund whose property rights were not mediated by the Treasury. Both the revenues and costs of the new social security system would consequently be governed by the revenue maximising incentives of the finance ministry in the context of the wider fiscal position. If the public finances look bad, in an unfunded welfare system entitlements are always vulnerable, as we explore further in a later essay.

The inclusion of pensions in the same unfunded scheme as working age welfare also stored up serious problems for the future. Reforms to working age welfare and pensions were made without proper appreciation of the interdependencies. Declining fertility rates and growing longevity have driven up the cost to working age people of pensions promises made in 1948. In an unfunded system, then, it is hardly surprising that efforts to control the growing costs of welfare have fallen primarily on its working age beneficiaries (although pensions also declined in relative value). This lack of clarity over the purpose of the national insurance fund has grown over time, with it increasingly looking and feeling like a slightly peculiar extension of income tax.

The second weakness in the system that was implemented in 1948 was the design of contributory benefits. Contributory

14 Nicholas Timmins, *The five giants: A biography of the welfare state*, (London: Harper Collins, 2001), 196.

entitlements were set well below the level Beveridge had calculated as required for subsistence.[15] However, the key mistake was to set contributory National Insurance benefits at a level that in many cases put them below means-tested entitlements.[16] The problem quickly grew. Since insurance benefits were up-rated only irregularly, they persistently slipped behind the value of the means-tested supplementary benefit safety-net, which was reviewed more often.[17] As a result, in a growing number of cases, only a family with an alternative source of income would notice the difference between means-tested and contributory support under the system. For single-earner households that dominated post-war society until the late 20th century, this was a distinction without difference.

More than anything else, the fact that contributory entitlements were never really sufficient to clear the means-test had important consequences for political support for the system. That contributors could see little apparent benefit to having contributed undermined an important source of legitimacy for the insurance based scheme.[18] As we explore in more detail in our third essay, even what little distinction there was subsequently withered. And from 1996, even the nominal distinction between insurance-based and means-tested unemployment benefits was erased. From the outset, then, contributors could reasonably claim that the system offered relatively little in return compared to non-contributors, and that problem got gradually worse.

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15 John Veit-Wilson, "Condemned to deprivation? Beveridge's responsibility for the invisibility of poverty" in *Beveridge and social security: an international retrospective*, eds. John Hills, John Ditch and Howard Glennerster (Oxford: Clarendon Press, 1994), 110.

16 John Hills, "Inclusion or Insurance? National Insurance and the future of the contributory principle', (ESRC Research Centre for Analysis of Social Exclusion, 2003), http://eprints.lse.ac.uk/5563/1/Inclusion_or_Insurance_National_Insurance_and_the_future_of_the_contributory_principle.pdf.

17 Rodney Lowe, *The welfare state in Britain since 1945* (London: Palgrave Macmillan, 1999), 147.

18 There was, of course a difference, in that contributory benefits are not means-tested. But, particularly given the gendered distribution of work in the early post-war world, this distinction would have been academic for many families.

These initial compromises to the internal logic of Beveridge's scheme proved to be the thin end of the wedge. Brief flirtations with earnings-related entitlements to both pensions and unemployment benefits in the 1960s and 70s never took hold. Changes to entitlements tended to make the system more redistributive, shrinking the costs of working age welfare by targeting the money increasingly at the poorest. Over time, as John Hills points out, the contributory principle was weakened by reformers of all hues on the entitlement side: by greater means testing of benefits to control costs usually by governments of the right; by the extension of coverage to non-contributing groups often by governments of the left; and by New Labour, who did some of each.[19]

In 1973 Unemployment Benefit was delinked from the basic pension, beginning four decades of falling relative value.[20] In 1996, the contributory Unemployment Benefit entitlement was cut from one year to six months under the new JSA regime. And in the face of today's fiscal constraints, the Coalition Government have honoured this tradition by reducing entitlement to contributory Employment Support Allowance (ESA) from indefinite to just one year, thus effectively cutting the value of previous contributions. This policy trend makes it clear that there is an ever-present threat that the value of contributions may be devalued by future policy.

Hills likens this gradual erosion of the contributory principle to the answer his friend gave to the question of why Denmark is smaller today than it was historically. "You have to understand", his friend said, "we lost fifteen battles in a row".[21] Lose enough battles, and in the end you lose the war.

19 Hills, *Inclusion or Insurance?*, 7.

20 Ibid., 8.

21 Ibid., 8.

Today, the flat-rate nature of unemployment benefits, whether claimed through he means-test or as the result of past contributions, means that JSA has inevitable become a lowest common denominator benefit. A flat-rate benefit regardless of past contribution was always destined to be seen as too generous for non-contributors and too stingy for those who have paid in.

On the contributions side too, the original principles were abrogated, destabilising the system politically, whatever the merits of the individual measures adopted. For example, in 1961, the Macmillan government replaced the flat rate contribution – the stamp – with earnings-related contributions up to a maximum (the Upper Earnings Limit). As earnings-related *entitlements* withered, while earnings-related *contributions* became entrenched, so the gap between the value of contributions and the value of contributory benefits grew – particularly for working age people. The cap on employer contributions was removed in 1985. And Gordon Brown perforated the Upper Earnings Limit for employees in 2006, with no upper limit on a one percent increment on National Insurance Contributions (NICs) to fund spending on the NHS. However justifiable the cause, this move exemplified the collapse of any meaningful distinction between a contributory system of welfare and the tax system.

It is easy to see how this drift away from prior contributions as a basis for entitlement has happened. National Insurance was never properly separate from the rest of the public finances, and as an unfunded scheme, entitlements had to be justified among other calls on government spending. When budgets are tight, the political impulse is to refocus spending on priority needs, and so to weaken contributory entitlements. This is made all the more possible politically because of the lack of any apparent difference between contributory and means-tested entitlements.

Individual decisions like the recent halving of contributory ESA entitlement might have merit in the circumstances, given the

alternatives and when viewed in isolation. But, over time, cuts to contributory benefits create an ever starker distinction between those who pay in and those who benefit, undermining contributors' confidence in the system.

The cumulative effect of these changes has been to further undermine the internal logic of the system. Beveridge's idea of unemployment benefits provided as a right to those who have contributed has become indistinguishable from the means-test, making the concept almost meaningless. And the large degree of redistribution involved at a point in time has further weakened political support. As an insurance scheme the unemployment support system has been hollowed out as the result of self-reinforcing political dynamics.

Had this been a private insurance scheme for working age people, it would have collapsed long ago under the weight of conflicting interests. Those who felt they were paying a lot in and getting little in return would have left the scheme, which would have made it unviable for those who remained. As exit from a mandatory system is impossible, this dynamic has manifested itself in the steady erosion of political support and further residualisation of an insurance system designed to protect people against destruction of earning power. The result is a social security system that looks fundamentally different from anything Beveridge sought to achieve.

These internal changes to the original blueprint over the early years of the scheme's implementation succeeded in minimising its costs and making it more redistributive. But in doing so they created a working age welfare system that rapidly lost public support. When these developments are seen in the context of the profound social change in the UK over the past 70 years, it is hardly surprising that our social security system is today politically friendless.

2. CHALLENGES FROM WITHOUT: CHANGING PATTERNS AND CONSEQUENCES OF SOCIAL AND ECONOMIC RISKS

As discussed above, broad political support for the social security system came under pressure because of its increasingly needs-based, redistributive nature. If it were the case that everyone's risk of unemployment, and the consequences of it, was equal then political support for social security might have proven more hardy. In reality, employment risks are not entirely random, so political support is heavily dependent on how accurately individuals can foresee them.

Profound social and economic changes over the past 70 years have made it increasingly obvious to citizens how likely they are to need the support of the state in future, as well as allowing ever greater numbers of people to provide for themselves. These changes – many of them welcome developments – have threatened the post war social security system from without.

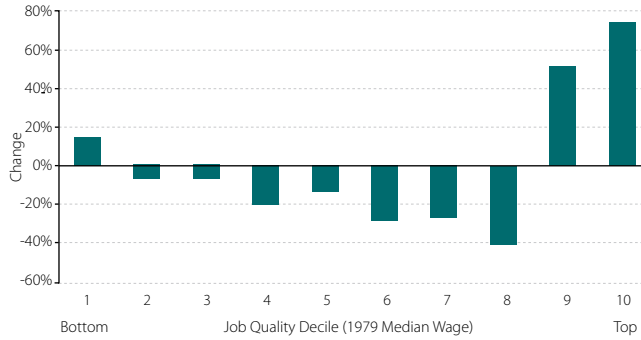
Economic changes

A number of inter-related economic trends over recent decades have had the effect of polarising the labour market, in terms of both pay and unemployment risk. Despite current political rhetoric about a revival of manufacturing, the transition to a post-industrial economy that has taken place in the post-war era is largely complete and irreversible. The manufacturing share of total employment has fallen from 27.2% in 1975 to 9.8% in 2009, and service sector jobs have filled the gap. This radical shift in industrial structure has been associated with big changes in the labour market: shrinking numbers of mid-skilled jobs offset by a large rise in high-skilled employment. A common explanation for this trend has been that technology is complementary to workers with high skill levels, such that 'skill-biased technical change' drives growing inequality in the labour market.

However, growth in high-quality jobs has not been the whole story over the past 30 years. Chart 1.4 shows how the share of jobs

in each decile from the lowest to highest paying in 1979, have changed up to 2008.[22] There has been a 'hollowing out' of the labour market, with employment growing in the lowest-quality jobs as well as the best. Machin and others attribute this hollowing out effect to the idea that technology – and IT in particular – is readily adaptable to many of the kinds of routine tasks that used to characterise the middle of the occupational distribution (craft manual jobs and bookkeeping, for example). This has lowered demand for mid-skilled workers and raised demand for high-skilled, non-routine jobs. That, in turn, has raised the demand for very low-skilled non-routine employment, like cleaning.

Chart 1.4: Polarisation of UK employment, 1979 to 2008



Source: Mieske (2009); percentage changes are for the entire period

These dynamics have been largely responsible for the growing polarisation in pay over the past forty years. Full-time male earnings at the 90th percentile have diverged markedly from those at the 10th. While in 1979 a man working full-time at the 90th percentile of the distribution would have earned around 2.5 times more than his counterpart at the 10th earning percentile, by 2009, that gap had

22 Stephen Machin, "Changes in UK wage inequality over the last forty years" in *The labour market in winter: the state of working Britain* eds. Paul Gregg and Jonathan Wadsworth (Oxford: Oxford University Press, 2011), 160.

increased to 3.7 times.[23] Fluctuations in the labour share of GDP appear to be mainly cyclical rather than showing evidence of an adverse long-term trend. But it is clear that share is increasingly captured by the highest skilled workers, and those at the very top in particular, resulting in greater income inequality within the workforce.[24]

All of this has had important implications for the politics of the UK's contributory welfare system. Workers who have a fair degree of confidence that they have the skills to put them in the top half on an increasingly bifurcated labour force can be much more confident of being able to protect themselves. The hollowing out of mid-skilled employment opportunities and growth of 'lousy jobs'[25] also raises the adverse selection problem that would undermine confidence in any voluntary insurance system. So economic trends have ratcheted up the pressure on the politics of the post-war social security settlement. But in themselves they would not have been as potent as they have been without their combination with some even bigger social trends.

Social changes

The rise in the proportion of women in employment over recent decades has been mirrored by a decline in the share of men in work. Between 1971 and 2013, the male employment rate fell from 92.1% to 76.2%, while the female employment rate rose over the period, from 56.4% to 69.6%. But steady progress towards more equal employment rates is not the whole story.

There has also been a steady convergence in the proportion of men and women in very stable long-term employment. This

23 ibid.

24 João Paulo Pessoa and John Van Reenen, *Decoupling of wage growth and productivity growth? Myth and reality*, (London: Resolution Foundation, 2012).

25 Alan Manning and Maarten Goos, *Lovely and lousy jobs: the rising polarisation of work in Britain* (London: Centre for Economic Performance, 2003).

has primarily been driven by a reduction in the share of long-term employment for men from 56.5% of those over 35 in long-term employment in 1985 to just 40.7% in 2009.[26] While it is hard to be sure of the drivers of this reduction in employment stability – the decline may reflect the preferences of employees as much as those of employers – the rapid decline in stability for low-skilled men illustrates their exposure to greater employment risk.

Combined with family and household trends, these dynamics have been magnified. Growing numbers of single adult households and the process of so-called 'assortative mating'[27] – whereby people increasingly marry someone from their own class – mean that the risks of worklessness are becoming more polarised across households.

The evidence of polarisation between two-earner and no-earner households is striking. Gregg and Wadsworth's analysis of the Labour Force Survey shows that while just 8.2% of households were workless in 1977, that proportion had more than doubled to 17.3% by 2009. Meanwhile the proportion of families where all adults in the household work rose over the period from 57.9% to 65.3%.[28] With the rise of dual-earner households, in particular, families' scope to insure themselves against employment risk has meant that reliance on social security has diminished, even in times of economic turbulence. All of this represents a marked change from the male breadwinner society into which the post-war social security system was launched, and for which it was designed.

26 Giulia Faggio, Paul Gregg and Jonathan Wadsworth, "Job tenure and job turnover" in *The labour market in winter: the state of working Britain* eds. Paul Gregg and Jonathan Wadsworth (Oxford: Oxford University Press, 2011), 100.

27 IPPR, "Modern women marrying men of the same or lower social class", *IPPR*, April 5, 2012, http://m.ippr.org/press-releases/111/8956/-modern-women-marrying-men-of-the-same-or-lower-social-class.

28 Paul Gregg and Jonathan Wadsworth, "Workless households" in *The labour market in winter: the state of working Britain* eds. Paul Gregg and Jonathan Wadsworth (Oxford: Oxford University Press, 2011), 100.

A polarising mix

The combination of these social and economic trends has had a powerful effect in undermining the basis for national unemployment insurance. The result is a story of two, increasingly distinct labour markets, where those within each face very different sets of risks, and have very different private capacity to manage them alone.

One labour market is characterised by opportunity, with well-paid jobs filled by highly-skilled workers, often drawn from a global pool of talent. While even these jobs are not as secure as they were, workers in this labour market can rely on the security of their employability and that of their partner. During periods of unemployment these households have much greater ability to self-insure, either through reliance on private savings derived from higher pay than in the past, or within the household through a working partner. Even in the face of structural economic change, if new opportunities using the same skill set are unavailable to these workers, there are plenty of jobs available on other lower rungs of the ladder they can take if needs be – the phenomenon known as "bumping down". For this group, the dynamism of the UK's labour market works to their benefit.

In the other labour market – the lower half of the hour glass – flexibility equates to employment insecurity, while the missing middle rungs of the occupational ladder put a cap on ambition and pay. It is here that labour market risk is most concentrated, and private capacity for self-insurance lowest.

Beveridge's scheme was designed to protect against risks of income loss from gaps in employment. While the likelihood of such a loss of employment income might have been higher for some groups than others, they were risks that were far more evenly distributed than they are today. Contributing while in work to cover the risk of unemployment was essentially a type of life-

cycle or 'horizontal' distribution. As Peter Taylor-Gooby has argued, the universal nature of these Old Risks made possible a politics of solidarity, with risks pooled within and across generations.[29]

By contrast, the New Social Risks – "the risks that people now face in their lives as a result of the social and economic changes associated with the transition to a post-industrial economy"[30] – are different in nature, incidence and consequences for those affected. In nature, they relate to access to labour markets and the subsidisation of market incomes, rather than simple a loss of market income. In incidence, they are more likely to bear on women, younger workers, and the low-skilled.[31] They affect minorities rather than majorities, and subgroups at particular stages in life. And while the incidence of these risks might be transitory and particular, their consequences are more significant for those who are affected.

If risks are serious but perfectly random, the whole population has an interest in a viable system of general insurance. But the more it is clear who is at risk and who is not, the harder it is to mobilise a broad coalition of support, even if – particularly if – the impact of those risks is more serious for those affected. This occurs because the system is seen less as an insurance system for all, and more as a redistributive system for a minority. Just as the significant impact of these risks on the lives of those affected increases the need for an effective public policy response, so their narrower incidence simultaneously makes this response less likely. This is the essence of the political dilemma for the future of working age welfare.

29 Peter Taylor-Gooby, 'New risks and social change' in *New risks, new welfare: the transformation of the European welfare state*, ed. Peter Taylor-Gooby (Oxford: Oxford University Press, 2004), 9.

30 Ibid., 2.

31 Ibid., 8.

CONCLUSION

In this essay we have set out the current crisis of legitimacy facing our system of working age welfare, and explained the deeps roots of the problem. What began as an insurance scheme based on the "magic of averages" became a minimalist redistributive safety net because of challenges from inside and outside the system.

- First, the challenge from within: we have explained how the logic of the system Beveridge designed was compromised from the start. The first weakness stemmed from the decision to combine pensions and unemployment insurance in an unfunded scheme, in which the interests of current contributors are pitted against those of current claimants. The second flaw was to obscure the contributory nature of the system by allowing insurance benefits quickly to become all but indistinguishable from the means-tested level available to those without a contributions record. The logic of the system became increasingly undermined as successive waves of reform tended towards increasing the gap between contributions in and expected benefits paid out.
- Second, the challenge from without: we have explained how the patterns of economic risks facing individuals and households have become ever more polarised as a result of economic and social changes over the past 40 years. Increasingly able to manage economic risks themselves, higher-skilled, better-off citizens have come to see the protections offered by our system of working age welfare as inadequate. This has led to the withdrawal of political support for this model of collective insurance and, for those who can, a growing reliance on self-insurance.

A market-based insurance system built in this way – with premiums rising for the least risky members – would have collapsed. Under a mandatory state-backed system we argue that the UK has

instead witnessed the political equivalent, through the widespread withdrawal of political support for our welfare system, leaving it increasingly residualised.

The idea that some are getting more than they might deserve – 'something for nothing' – is a toxic charge. But as recent government analysis has shown, even in normal economic times, unemployment comes as an unexpected shock to a large proportion of those who experience it each year and, despite having contributed, these people find only meagre support on offer. The charge that the system offers contributors 'nothing for something' is therefore also an important part of the politics of welfare. This is the inevitable result of a flat-rate, lowest common denominator unemployment benefit regime.

In setting out the driving forces behind the collapse of legitimacy, this essay implicitly outlines the tests for any durable system of welfare. It must be designed to avoid the internal weaknesses that have plagued the 1948 system from the outset; and it must be politically durable in the face of ever-greater diversity of economic risks across society.

The crisis of legitimacy in the post-war social security system has been building for a generation, so the idea of reform is far from new. In the next essay we explore the orthodox policy response, adopted by governments of all parties over the past 30 years.

ESSAY 2: THE TRUTH ABOUT WELFARE

Ian Mulheirn and Jeff Masters

> *"Unemployment benefits provide a 'search subsidy' for giving the unemployed time to find, not just a job, but the right job."*
>
> R. Marimon and F. Zilibotti

THE ORTHODOX PRESCRIPTION

The crisis of legitimacy in our social security system was largely masked during the years of steady economic growth between 1993 and 2007. But the current period of austerity has magnified the problem as the need to cut public spending brings the benefits system under greater scrutiny. The Coalition Government has made it a priority to reform working age welfare, and to cut its cost.

The Coalition sees cutting the cost of the benefit system and encouraging work as the way to shore-up the system's legitimacy in the face of hardening public attitudes. In its drive to save money, the Government's direction of travel consists of three very orthodox strategies: strengthening financial work incentives, simplifying the benefit system, and increasing the pressure on claimants to get back to work quickly. In this second essay, we look at these policies, the evidence on their effectiveness, and the likelihood that they represent a solution to the deep legitimacy problems faced.

These approaches have had some successes, particularly in limiting long-term unemployment in the current recession. But by prioritising jobseekers' rapid return to *any* job, over finding the *right* job, our labour market institutions encourage a high turnover labour market that wastes valuable human capital and discourages its accumulation. In doing so, they reduce the productivity of the UK workforce.

Work incentives

The first policy goal, in the usual approach to unemployment, is to strengthen financial incentives to work by raising the gap between out-of-work benefit entitlements and what income people receive in work. This can be achieved both by raising in-work incomes through and by cutting out-of-work entitlements. So what is the Coalition doing in this area?

The Liberal Democrat drive to substantially increase the income tax personal allowance is providing a significant boost to all basic rate taxpayers, although spending on this reform is not particularly well-targeted on the lowest-paid, whose financial work incentives are weakest. Iain Duncan Smith's Universal Credit reform, due to be rolled out from April 2014, has been promoted as a means to make work pay. In reality, incentives to move into work will improve for some and deteriorate for other. Rises in in-work support for some groups such as parents working fewer than 16 hours, will be paid for by reductions in in-work support for other groups such as second earners, whose incentives will deteriorate.[32]

Overall Universal Credit will only have a marginal impact on financial incentives to move into work, at the point when it is introduced. Given cuts to the generosity of its constituent parts over recent years – including freezes to the Working Tax Credit elements, reductions in Council Tax Benefit, and a cut in childcare support from 80% of costs to 70% from April 2011 – it appears that in-work support for most will be significantly lower by 2014 than it was under the system that the Coalition Government inherited in 2010. This is, perhaps, inevitable given the fiscal situation.

32 Mike Brewer, James Browne, Wenchao Jin, "Universal Credit: a preliminary analysis" (Institute for Fiscal Studies, 2011), www.ifs.org.uk/bns/bn116.pdf.

The other side of the work incentives coin is, of course entitlement levels for the unemployed. At the time of a tight public spending squeeze, reducing out-of-work entitlements to strengthen negative financial incentives has unsurprisingly come onto the policy agenda. The June 2010 Budget, October 2010 Spending Review and 2011 Autumn Spending Review all included substantial cuts to housing benefit and tax credits that reduced entitlements for those out of work and will continue to erode their relative value, sharpening work incentives (even though they also cut support for claimants who are in work).

The case for going further down this route was set out by the Prime Minister, David Cameron, in his speech in June, 2012 in Bluewater, Kent. Looking towards the priorities for a future Conservative government in cutting the welfare bill, Cameron articulated the legitimacy problem in terms of a 'welfare gap' between those who claim from the welfare system and those who seek to lead autonomous lives:

> *"[W]e have, in some ways, created a welfare gap in this country between those living long-term in the welfare system and those outside it. Those within it grow up with a series of expectations: you can have a home of your own, the state will support you whatever decisions you make, you will always be able to take out no matter what you put in. This has sent out some incredibly damaging signals. That it pays not to work. That you are owed something for nothing. It gave us millions of working-age people sitting at home on benefits even before the recession hit. It created a culture of entitlement.*
>
> *"And it has led to huge resentment amongst those who pay into the system, because they feel that what they're having to work hard for, others are getting without having to put in the effort. The system is saying to these people: Can't afford to have another child? Tough, save up. Can't afford a home of your*

own? Tough, live with your parents. Don't like the hours you're working? Tough, that's just life. So there is a real welfare gap that exists in our country." [33]

The 2012 Autumn Statement was evidence of a further step in this direction as the Government seeks to make more savings. It plans to save around £2.5bn from working age benefits including JSA, tax credits and housing benefit by 2015 by restricting annual uprating to just one per cent, irrespective of inflation. To the extent that these are effective at improving work incentives, some of that advantage will be undone by simultaneous reductions to in-work support as DWP trims in-work Universal Credit entitlements by a further £1bn by 2016, on top of current freezes to Working Tax Credit. Nevertheless, in taking this line, the Coalition Government has sought to offer an active and robust response to one of the key threats to system legitimacy: the perception of a system without limits to those who would make unlimited demands.

Simplification

The second element of the Coalition's approach is to simplify the benefits system. The Universal Credit is central to this ambition, rolling together the six main means-tested benefits and tax credits.[34] This is thought to have three advantages. First, clarity on in-work entitlement levels (it is hoped) will remove claimants' fears that they will be worse-off in work, maximising the potency of financial work incentives in the system. Second, a simple, unified system removes (or at least reduces) the administration burden and risks for families associated with having to claim a new form of support when moving into work. This also reduces the fear among claimants that they will find it hard to reclaim benefits if their move

33 Rt Hon David Cameron MP, Speech on welfare reform, cited in "David Cameron's welfare speech in full", *The Daily Telegraph*, June 25, 2012, www.telegraph.co.uk/news/politics/david-cameron/9354163/David-Camerons-welfare-speech-in-full.html.

34 Income Support, income-based Jobseeker's Allowance, Employment and Support Allowance, Housing Benefit, Child Tax Credit and Working Tax Credit.

into work ends badly. The Department for Work and Pensions estimates that these simplification benefits will increase the number of people in work by 50,000 to 100,000.[35] Third, a simpler system is likely to be less prone to claimant or administrative error and fraud, potentially cutting a proportion of the £5.2bn estimated annual costs of fraud and error in the current benefit system.[36]

As well as these instrumental benefits of simplicity, all else equal, a simpler benefit system must be an intrinsically good thing, and government has a duty at least to try to design a tax and benefit regime that is comprehensible to citizens. But means-tested benefit systems are inevitably complex if money is to be targeted at those who need it. Indeed, unnecessary complexity is already creeping into the Coalition's reformed system for reasons of economy. The localisation of Council Tax Benefit will lead to a plethora of different local regimes. The treatment of so-called 'passported' benefits – like free school meals – risks adding further complexity.[37] All of this casts doubt on the Government's claim to be simplifying the system.

Activation policies

The third part of the Government's response to the legitimacy crisis is to strengthen activation policies. This includes measures designed to encourage people back to work quickly both by encouraging them seek work, but also by making a life on benefits uncomfortable. Activation strategies are given teeth by strengthening 'conditionality' on claimants: raising the work search requirements and threatening tougher benefit sanctions for non-compliance.[38]

In October 2012, the Government introduced new sanction rules for the JSA regime. The new framework allows Jobcentre Plus

35 Department for Work and Pensions, Universal Credit Impact Assessment (London: DWP, December 2012), 29.

36 Ibid., 9.

37 Kiran Stacey and Sarah Neville, "Universal Credit holds up reforms", *Financial Times*, March 12, 2013, www.ft.com/cms/s/0/5f13fdbe-872e-11e2-bde6-00144feabdc0.html#axzz2NQpnfHmx.

38 Department for Work and Pensions, *Universal Credit: welfare that works* (London: HMSO, 2010), 28.

advisors to impose substantially larger and longer benefit cuts on those claimants deemed to be looking insufficiently hard for work, or refusing to take jobs that are offered. The goal is to strengthen work incentives through closer monitoring of claimants to ensure that they are 'deserving' of support and greater efforts to push them back to work. In other words, the legitimacy of a claim will increasingly come to depend on a claimant's *current* behaviour, rather than their past contribution. The stigma that attaches to greater benefit conditionality is, on this view, also effective in increasing the desire of claimants to get back to work.

None of the three underlying insights on work incentives, simplification and activation are particularly new. In fact, each aspect of the Coalition's policy represents an intensification of the underlying logic of reform over the past generation, rather than a challenge to it. As a look back at policy developments over that period shows, the current approach represents another effort to make the unemployment system more effective at getting people into work using the same tools that governments have been using for decades.

A GENERATION OF REFORM

On financial work incentives the direction of travel has been very consistent since Norman Fowler's 1986 Social Security Act. Universal Credit is therefore the latest evolution in a long line of efforts to make work pay more than benefits (to break the 'unemployment trap'), and increase incentives to progress in work (to reduce the intensity of the 'poverty trap') for those facing the highest benefit withdrawal rates. In fact, the idea of wage subsidies to strengthen financial work incentives for families, who have higher costs, began with the Family Income Supplement (FIS) in 1971. The FIS subsequently became the more generous Family Credit in Fowler's 1986 Social Security Act. It was then briefly the Working Families

Tax Credit from 1998, which was significantly more generous again to working families, before becoming Tax Credits system in 2003.

Broadly, the Fowler reforms reduced the generosity of benefits to those not in work, while boosting them for working families with children.[39] The 1997 to 2010 Labour governments followed a very similar trajectory, focusing on boosting the levels of financial support, both in and out of work, for families with children. Yet, the unemployment benefit part of the system continued to wither, sharpening financial work incentives for childless people by reducing their entitlement in relative terms. The recent Welfare Benefits Up-rating Bill, restricting rises to one per cent for each of the three years from 2013–14, will further reduce the relative and real value of most benefits. As a result of these trends, Jobseeker's Allowance, the successor to Unemployment Benefit, has been static in real terms for forty years, and is now beginning to fall.[40] Relative to average earnings, the value of unemployment benefits has plummeted over this time period, all of which has strengthened work incentives.

While the Coalition's recent reforms reflect the need for spending cuts to eliminate the fiscal deficit, the longer-term trend to raise financial gains to work is largely the product of theory and evidence about the impact of benefits on the labour market. From the 1980s onwards, an influential body of literature stressed the role of high unemployment insurance in slowing the pace at which people return to work.[41] Generous out-of-work support makes leisure time more attractive and reduces the financial gain to work. Where benefits are higher, all else equal, people will therefore be

39 Martin Evans, David Piachaud and Holly Sutherland, *The effects of the 1986 Social Security Act on family incomes* (York: Joseph Rowntree Foundation, 1994).

40 Peter Kenway, *Should adult benefit for unemployment now be raised?* (York: Joseph Rowntree Foundation, 2009), 12.

41 See, for example, Bruce D. Meyer, "Unemployment insurance and unemployment spells", *Econometrica*, 58: 4 (1990).

less inclined to return to work, or will be more choosy about what work they take. They will, in the economic jargon, have higher 'reservation wages'. In a survey of the extensive literature on this topic, Kreuger and Meyer conclude that a one per cent increase in unemployment insurance raises the level of lost work time in aggregate (in terms of both more and longer unemployment spells) by around the same proportion.[42] Layard et al report that, for the UK, a one per cent rise in benefit generosity increases average unemployment duration by between 0.3 and 0.8 per cent.[43] Lowering reservation wages by offering meagre support will therefore cause more people to get back to work as soon as possible in response.

The benefit simplification agenda of the Coalition's Universal Credit project was also foreshadowed by Gordon Brown's tax credits reforms. The rationale for the latter was partly to create a "seamless system of support for families with children" forming a "stable and secure income bridge as families move off welfare and into work".[44] Simplicity and predictability in the benefit system, it was hoped, would induce more people to get back to work.

But sharpening work incentives and simplifying the benefit system have not been the only aspects of policymakers' assault on reservation wages. In addition, much evidence from the literature has pointed to the effectiveness of increasing benefit conditionality. In advancing this agenda, the current government is advocating going further down the road of reform that policy has been on for the past 27 years, since Margaret Thatcher's government introduced the Restart Programme to toughen work search requirements on

42 Alan Kreuger and Bruce D. Meyer, "Labour Supply Effects of Social Insurance", NBER Working Paper 9014 (Cambridge, MA: National Bureau of Economic Research, 2002).

43 Richard Layard, Stephen Nickell and Richard Jackman, *Unemployment: Macroeconomic performance and the Labour Market* (Oxford: OUP, 2005), 255.

44 HM Treasury, *The Child and Working Tax Credits: the modernisation of Britain's tax and benefits system* (London: HMSO, 2002), 3.

Unemployment Benefit claimants. Threatening benefit sanctions if claimants do not engage in sufficient work search activity has been found to further expedite the claimant's return to work for three main reasons.[45] First, it turns unemployment leisure time into something less enjoyable, causing claimants to lower their reservation wages. Second, the threat of benefit sanctions is effective at getting people to raise their search rate. And third, as the intensity of monitoring and mandated activity rises during a spell on benefits, the anticipation of those changes appears to be effective at raising the rate of return to employment.[46]

To the extent that shorter unemployment durations are the desired end of policy, this framework of reducing reservation wages by restricting out of work benefits and using conditionality has been shown to be effective. But this is a narrow definition of success. The aim of the strategy has been to make the system more acceptable by reducing the inevitable economic drag that it is thought to entail. For the past 30 years policymakers have therefore sought to tackle the legitimacy problem by minimising it: residualising large parts of the safety net and getting people back to work quickly. This is a plan that the Coalition – under intense fiscal pressure – wants to push harder. But have the successes of this strategy really been unalloyed? And how effective will it be if pushed further?

SHORTCOMINGS OF THE ORTHODOXY

The orthodoxy of the past generation has achieved a number of successes. Some of those have been evident since the 2008 recession. Professor Paul Gregg has highlighted the availability of more generous in-work support as one reason why unemployment

45 Simon Burgess and Patrick Garrett, "A dynamic approach to Europe's unemployment problem: policy report", CEPR Policy Paper 11, (2005), 20, www.cepr.org/pubs/policypapers/pdf/pp11.pdf.

46 Julia Griggs and Martin Evans, *Sanctions within conditional benefit systems* (London: Joseph Rowntree Foundation, 2010), 17.

rose far less than history would have led us to anticipate in the face of such a large fall in output.[47] Meanwhile, activation strategies appear to be being effective at keeping a lid on the level of sickness benefit claims. Economically inactive people represent 22.3% of the working age population, and the number of claimants has fallen by 294,000 on one year ago.[48] They have also been very effective at stopping people from slipping into damaging long-term unemployment, which has risen less in the recent recession than it has in previous recessions. These are considerable successes in the teeth of a stagnating economy, especially compared to the failures of the 1980s and 1990s.

Yet the relatively successful performance of the labour market in the recent years of economic turmoil has masked some undesirable dynamics that became evident well before the recession struck. First, we should re-examine just how economically efficient some of the aspects of the orthodox approach really are. Second, trends in employment policy have had other social consequences which have largely been ignored and may be undesirable. Third, even if we are content with the economic and social consequences of the current direction of travel, does it represent a sustainable solution to the legitimacy crisis facing social security?

Economic efficiency?

Sharpening financial incentives to work and pushing people to seek work quickly are at the heart of the strategy, but new evidence suggests that they can be harmful to the efficient functioning of the labour market.

In the current fiscal context, strengthening financial work incentives mainly implies reducing out-of-work entitlements, rather than raising in-work subsidies (as has tended to be the case in times

47 Paul Gregg and Jonathan Wadsworth, "Unemployment and inactivity in the 2008–09 recession", *Economic & Labour Market Review* 4:8, (2010).

48 Office for National Statistics, "Labour market statistics, February 2013 (London: ONS, 2013), 24.

of plenty). On this view benefits may be a social necessity but they are an economic drag to be minimised. But this is an inadequate description of how the labour market works and the role that unemployment benefits play. And it is questionable that the results will be economically optimal, particularly where jobseekers have valuable skills or experience.

There is a growing body of evidence that, while forcing people back to work quickly may be superficially attractive, it may damage productivity where skilled and experienced workers are concerned. Standard approaches to the analysis of unemployment benefits have focused on the effect of high replacement rates in lengthening unemployment duration (the problem of moral hazard is explored in more detail in the next essay). But their role in allowing people time to search for the right job has increasingly been seen as important and overlooked by policymakers. In a world with workers having diverse skills and employers with diverse labour requirements, productivity depends crucially on the effectiveness of the job search and matching process. Acemoglu and Shimer argue that in a world without, or with low levels of, unemployment insurance, workers "avoid the risk of unemployment by applying to low productivity jobs that are easier to obtain". On this analysis, where unemployment insurance is too low, the labour market does not function effectively: "The resulting composition of jobs is inefficient and can be improved by a moderate level of unemployment insurance, which encourages workers to take on more risk, and increases both welfare and the level of output."[49]

As Marimon and Zilibotti put it "Unemployment benefits provide a 'search subsidy' for giving the unemployed time to find, not just a *job*, but *the right job*" (emphasis theirs).[50] In the context

49 Daron Acemoglu and Robert Shimer, "Productivity gains form unemployment insurance", *European Economic Review* 44 (2000), 1196.

50 Ramon Marimon and Fabrizio Zilibotti, "Unemployment vs. mismatch of talents: reconsidering unemployment benefits", *The Economic Journal*, 109 (1999), 267.

of ongoing technological change and the economic restructuring that occurs in a recession, the importance of making the right job match grows, hence the returns to search increase. As the OECD has argued, the benefits of better job matches go further than just making the best use of existing skills.[51] Good matches lengthen job tenure, which improves employees' skills through both experience and their greater likelihood of receiving further training. Poor matches cause workers' prior skills to deteriorate, making past training redundant and raising staff turnover. And in an environment where getting people back to work immediately is the policy priority, there is little incentive for workers to invest in their own skills. These dynamics may be behind growing wage inequality in the US relative to continental Europe. Evidence of increased skills mismatch, and resulting wage inequality growth in the US between the 1970s and 1990s therefore finds some explanation in lower levels of unemployment insurance reducing search activity among the unemployed.[52]

None of this is to deny that more generous unemployment benefits also dampen incentives to find work. The policy challenge is to strike the right balance between allowing people too much and insufficient time to search. The optimal trade-off varies according to how skilled a given worker is and how long they have been workless. But recent evidence suggests that the UK's flat rate unemployment benefit doesn't serve us well.

Harvard's Raj Chetty has estimated that the majority of increased unemployment durations associated with higher unemployment benefits result from what he terms 'liquidity effects' rather than labour market distortions.[53] In other words, since a large proportion

51 OECD, *Employment outlook*, (Paris: OECD, 2006), 75.

52 Ramon Marimon and Fabrizio Zilibotti, "Unemployment vs. mismatch of talents: reconsidering unemployment benefits", *The Economic Journal*, 109 (1999), 267.

53 Raj Chetty, "Moral Hazard vs Liquidity and Optimal Unemployment Insurance", *NBER Working Paper No. 13967* (2008), 34.

of unemployed people in the US report having no savings to draw on, they cannot afford to turn down work ill-suited to their skills, despite that being in their and their employer's long-term interest. This has a damaging effect on productivity, hence higher levels of unemployment insurance benefits can make the labour market function more efficiently.

But it isn't just the orthodox strategy on benefit generosity that now looks shaky. The efficacy of tough sanction regimes is also of questionable economic value for many jobseekers, particularly if it isn't combined with high-quality job search support. Evidence on the labour market impact of an exacting sanctions regime is patchy, but what evidence there is echoes the findings on the effects of different unemployment benefit levels. Tough conditionality and benefit sanction regimes do indeed raise the rate at which people return to employment, and this has, for the past 30 years, been equated with 'successful labour market policy'. However, going deeper shows that all is not what it seems. Arni et al, using Swiss data, find that sanctions substantially reduce the quality of post-unemployment jobs in terms of both wages and employment stability.[54] This dynamic contributes to the higher levels of labour market churn seen in the UK labour market. Nine out of ten JSA claimants are back to work within 12 months. But Alasdair Yeo has found that, among short-term JSA claimants who find work, fully 73 per cent have left it again within a year, suggesting that extremely poor job matching is a consequence.[55]

The consequences for welfare and output of cutting entitlements for the unemployed from already modest levels, and ratcheting up sanctions, are therefore at best theoretically ambiguous, and probably negative. This is particularly the case for skilled workers for whom

54 Patrick Arni, Rafael Lalive, Jan van Ours, "How effective are unemployment benefit sanctions? Looking beyond unemployment exit", IZA discussion paper 4509 (2009), 32.

55 Alasdair Yeo, *Experience of work and job retention among lone parents: and evidence review* (London: HMSO, 2007), 47.

better job search would result in putting their skills to better use. When we look at the skills composition of those in unemployment the problem becomes clear. Among those unemployed for up to three months, Labour Force Survey data from the third quarter of 2012 suggests that around half have significant skills at Level 3 (equivalent to A-level qualifications) or higher. Around a quarter have a degree level qualification.[56] As a country we cannot afford to have skilled people doing jobs that do not make use of their skills.

Over time, such dynamics may well be important drivers of growing wage inequality and the polarisation of the labour market seen in the UK over the past 30 years.[57] Consequently, strategies to cut out-of-work entitlement levels below the optimal level can be thought of as a 'low equilibrium' solution aimed at limiting any negative risks, but at potentially high cost in terms of welfare and economic output. Minimising the cost of out-of-work benefits at any one point in time appears to be dynamically inefficient, contribute to growing wage inequality, and result in ever-greater reliance on further expensive policy interventions such as wage subsidies.

Social consequences of the orthodoxy

The strongest claim of the orthodox policy approach lies in its arguments from economic efficiency, but as we have seen, these claims are highly questionable once entitlements become meagre and conditionality stringent. But beyond arguments about efficiency, the economic reasoning of the orthodox prescription has given rise to three broader trends that are relevant to the idea of contributory welfare: the changing relationship between social security policy and economic policy; the erosion of an association between prior contributions and benefit entitlement; and a prioritisation of 'tidy', transactional welfare. Each of these may be unwanted consequences.

56 Labour Force Survey, July to September 2012.

57 Stephen Machin, "Changes in UK wage inequality over the last forty years" in *The labour market in winter: the state of working Britain* eds. Paul Gregg and Jonathan Wadsworth (Oxford: Oxford University Press, 2011), 160.

1. The separation between social security policy and economic policy has grown

Beveridge had viewed social security policy and economic policy as intimately related, with the attack on the Giant of Idleness through a commitment to full employment underpinning the viability of his strategy for addressing Want. This view has come to be replaced by a dominant intellectual approach that has seen working age welfare as a social necessity but an economic drag. On this view, while a safety net is desirable, the economic consequences for work incentives are entirely negative – both for the claimant and for the taxpayer who funds the benefits (often the same person at different points in the life-cycle). This dichotomy is highly questionable given the evidence above. But it also contrasts with other European welfare systems where the design can be viewed as reinforcing sources of national competitive advantage.[21] In the context of the UK, the link between welfare and work is mostly viewed in terms of a means of reducing the welfare bill. Beyond the understanding that higher labour market participation increases output in aggregate and reduces tax rates, there is little discussion about the relationship between our welfare system and the nature of our economy, for example through its impact on skill development and deployment.

2. Prior contributions versus current needs

The relentless logic of the orthodox argument has added to the financial pressure on a system where unemployment benefit entitlement was previously legitimised on the basis of *prior* contributions. The focus has instead shifted to *current* needs and work search activity as the qualification for a claim. In a sense this reflects a time inconsistency problem for government: while a contributory social security system may be easy to sell to voters, the temptation for government subsequently to renege on entitlements in order to maximise revenues and minimise social security expenditure is strong, particularly when the funding system is indistinguishable from the wider public finances.

The cumulative effect of this trend in working age welfare away from contributory benefits and towards means testing has been two-fold. The first has been to shift the balance of the system away from encouraging the 'good' (like the development and deployment of human capital), towards having to prevent the 'bad' (relying on benefits instead of working). The second has been to increase demands for greater conditionality for claimants: increasing administrative boundaries, both in an attempt to counteract the risk of people languishing on benefits, and as a way of demonstrating to tax payers that claimants are making the requisite efforts to justify public support.

3. 'Clinical' welfare

Finally, objectively administered, procedurally fair, state funded 'tidy' welfare has come to dominate at the expense of messier, more subjective, relational approaches. Tidy welfare favours verifiable, bureaucratic, procedural fairness over outcome fairness; treats individuals as rational utility maximisers, focusing on narrow incentive structures like gains to work; and prefers the certain, measurable, evenness of tax funded redistribution over other means of improving welfare. There are many good reasons to applaud the values tidy welfare embodies. It represents non-discriminatory, procedural fairness, and transparent objectivity in the way public resources are distributed. These must remain foundational requirements of legitimate public policy in any sphere. But while tidy welfare might offer the simplest way of meeting these requirements, it is not the only way. Nor might we view these as the only important public policy values.

A solution to the legitimacy crisis?

Not only is the orthodox approach questionable on its own terms, then, but it also has broader social consequences that may be undesirable. But even if one rejects all these problems, one is bound to ask: as a solution to the legitimacy of the system, can the orthodox approach ever succeed?

Although it identifies the problem of benefits blunting incentives to work as being at the core of the problem of legitimacy, it does not seek to address that issue directly, only to limit its consequences by reducing support. By focusing on limiting the downside risks for the system, it does not provide a positive case for the system. At best, it will make net contributors marginally less resentful. But ultimately, it is risky because it demands that a line is drawn between those who – at any point in time – are beneficiaries of the system and those who are paying for it. Of course, the reality is more fluid as people move from work onto benefits and back into work. Recent DWP research, cited in the first essay in this series, shows that among typical adult claimants of JSA in 2010–11, some 40 per cent have no recent history of an unemployment benefit claim. Almost 80 per cent of claimants have spent the large majority of recent years off benefit.[58] Overwhelmingly, tomorrow's claimant is today's taxpayer.

But by drawing this distinction it also exacerbates the problem it is aimed at addressing. The sharper the distinction drawn between those who, at any particular point in time, are claimants or contributors, the greater the challenge of creating legitimacy. Reinforcing these distinctions weakens the idea of a system that – overall and across the life cycle, indirectly as well as directly – should benefit all.

CONCLUSION

For the most part, today's claimants of unemployment benefits are tomorrow's contributors. But this fact is far from clear in the current debate and so maintaining the political acceptability of the system appears to require cutting entitlement and tightening the behavioural conditions attached to claiming beyond the point

58 Department for Work and Pensions, *JSA benefit histories and benefit receipt* (London: DWP, 2013), http://statistics.dwp.gov.uk/asd/asd1/adhoc_analysis/2013/ad_hoc_jsahistory_final.pdf.

where they become economically damaging. Labour markets need well designed institutions in order to thrive. For skilled and experienced workers a minimal, laissez-faire approach is particularly inappropriate, and it is damaging the productivity of our workforce.

The path of greater conditionality, lower benefits and increasing residualisation is therefore a bleak prospectus and a limited solution. Rather than address the problem of legitimacy at its core, its highest ambition is to minimise it, while offering no positive story about the interaction between the welfare system and the labour market. The orthodox prescription that has dominated policymaking for the past generation has had important successes in tackling problems such as long-term unemployment. But that approach is running out of road. It does not offer answers to the labour market challenges we face today, nor can it provide us with a social security system that commands widespread support. A radical alternative is sorely needed.

ESSAY 3: RE-ENGINEERING CONTRIBUTORY WELFARE

Ian Mulheirn

> *"We are going to design a new plane from the models that have crashed on the runway"*
>
> Sir Lance Errington, Permanent Secretary at Social Security, 1974.[59]

INTRODUCTION

The default strategy among policymakers is to intensify the orthodox approach to reforming unemployment policy, as described in the last essay. But an increasing number of people are now seeking to change the direction of reform. Central to that project is the goal of reinvigorating the idea of collective insurance, and making the 'contributory principle' meaningful again. Labour, as part of its policy review, is currently exploring this direction for reform,[60] and it recently emerged that the Conservatives, too, have been floating the idea of linking benefit entitlement to past tax or national insurance payments.[61] A strengthened contributory principle, it is hoped, would solve the problem of legitimacy not by reducing entitlements or raising conditionality, but by basing entitlements more explicitly on claimants' *past* behaviour. As Liam Byrne put it in a speech to the Social Market Foundation in July 2012,

> *"I believe we should renew the something for something bargain that gave the Beveridge such a wide appeal for working people."*[62]

59 Nicholas Timmins, *The five giants: A biography of the welfare state*, (London: Harper Collins, 2001), 345.

60 Jonathan Freedland, "Labour must draw the sting from welfare or lose in 2015", *The Guardian*, April 5, 2013.

61 Christopher Hope, "Conservatives float two-tier benefits system in private survey in Labour marginal", *The Telegraph*, May 17, 2013.

62 Rt Hon Liam Byrne MP, Speech to the Social Market Foundation, 23 July 2010, *Renewing the reward of responsibility*, www.smf.co.uk/files/4413/4305/9518/Third_Beveridge_Speech_-_July_2012_-_Final_Draft_2.pdf.

His robust advocacy of the contributory principle has been echoed by others on the left, including the late Malcolm Wicks MP,[63] and Kate Bell and Declan Gaffney, who recently explored the idea of a contribution-based top-up to Jobseeker's Allowance (JSA) as one option for reform.[64] This essay explores the principles behind a contributory social security scheme of the conventional kind, and the challenges involved in making such a system robust and enduring.

There are a number of alternative models of contributory welfare. Typically, the idea involves some form of insurance where individuals acquire benefit rights as the result of prior contributions. A contributory aspect still exists in the current social security system: those with a contribution record of 12 months out of the previous two years are entitled to six months' JSA and one year's Employment Support Allowance (ESA) without being subject to a household means test to determine eligibility. But the system's claim to be contributory has always been weak, as earlier essays in this series have discussed. From the early years of the post-war system there was little apparent financial advantage to having contributed.

If the contributory principle is to become meaningful again as a basis of working age welfare, it would need substantial reform. If it could be made to work again, there could be significant advantages in terms of tackling some of the damaging consequences of the orthodox policy approach that are increasingly becoming apparent. A reinvigorated contributory principle could strengthening the link between work and welfare, boost workforce productivity, and facilitate economic change while limiting painful social consequences. So what would it take?

63 Malcolm Wicks MP, Speech to IPPR, 24 April 2012, *Rights, wrongs and responsibilities: citizenship and social policy*, www.ippr.org/articles/56/9105/balancing-rights-and-responsibilities--rebuilding-the-social-security-system-in-the-21st-century.

64 Kate Bell, Declan Gaffney, "Making a contribution: social security for the future", Touchstone Pamphlet Number 12 (London: TUC, 2012).

WHAT COULD A CONTRIBUTORY WELFARE SYSTEM LOOK LIKE?

Achieving a more politically stable system that offers better support to people with a strong employment record is the goal. But getting to that destination involves trade-offs. To rehabilitate the idea of a contributory unemployment insurance system, four hurdles need to be overcome.

- First, the system needs to resolve the 'free-rider' problem, by tackling the **'something for nothing'** issue.
- Second, it must ensure an approximate relationship between payments made to the system by contributors, and what each person perceives they are likely to get out of it during their working life. It must, in short, tackle the **'nothing for something'** problem.
- Third, as with any insurance scheme it must restrict the likelihood that claimants will change their behaviour because they don't bear the cost of drawing on the system, **minimising moral hazard**.
- Finally, a contributory system must be designed to be distinct from the rest of the public finances, **keeping the bean-counters out**, so as to avoid being subverted by government over time.

Resolving each of these issues tells us something about the design of a viable contributory welfare system. But achieving it would be a major political undertaking. In any case even a sustainable contributory scheme can only tackle part of the crisis of legitimacy in the current welfare system, since the challenges of the means-tested safety net will remain unresolved. These are not value judgements about the character or generosity of a contributory welfare system, but a description of the fundamental economic forces that need to be considered in designing any workable scheme. In what follows, we explore each idea in turn.

Ending 'something for nothing'

At the core of any contributory welfare regime is the exclusion of people who have not paid in from the entitlements of those who have. As discussed above, it is a condition that the post-war social security system conspicuously failed to achieve. The exclusion of non-contributors is essential to any stable insurance system. Without a solution to the so-called 'free-rider' problem, the system is highly vulnerable to exit from those who do contribute (in the case of voluntary insurance schemes) or political pressure to dismantle the system (in the case of compulsory national systems), of the kind we see today.

Free-riders can be excluded by setting rules, such as having to have paid into the system for 12 or 24 months, before being entitled to contributory support. Indeed, as we have seen, the UK ostensibly operates a contributory system with a two-year qualifying period. But since contributory entitlement in the UK doesn't exceed the means-tested benefit rate, it is far from obvious that those who have contributed are treated preferentially.

In other systems that distinction is much clearer. In Germany's compulsory insurance scheme, entitlement to Unemployment Benefit is conditional on a record of contributions to statutory unemployment insurance, and entitlements are more generous than for the means-tested social assistance scheme Unemployment Benefit II. Another model is the voluntary Danish Flexicurity system. In this system claimants must have a contribution record, but the cost of contributions is relatively high. This effectively prices out anyone in very low-paid, and hence more risky, employment.

These examples highlight a central policy trade-off. The more one limits the coverage of the insurance scheme to those people at lower risk of unemployment, the less the system is vulnerable to adverse selection and political pressure, but the more an alternative support system is needed for higher-risk people. What emerges

from efforts to tackle the free-rider problem then is an inevitably two-tier system: a contributions-based system with more generous entitlements, and a means-tested safety net for those who do not qualify or cannot afford to be part of such a scheme.

As we have already seen, Beveridge's intention was that there should be a clear distinction between the entitlements of contributors and non-contributors. But since the 1948 rates of Unemployment Benefit were set too low to clear the means-tested support entitlement for many, and the situation was quickly allowed to deteriorate, that crucial element of the design was missing. Since 1996, with the introduction of JSA, even the nominal distinction was lost, as (contributory) Unemployment Benefit and (means tested) Income Support were rolled together into a benefit with one name, even if what remains of the contributory principle still benefits unemployed people with a working partner.

Bell and Gaffney recently looked at the option of introducing a flat-rate, contribution-related top-up for JSA, to create the necessary distinction.[65] So would the introduction of a uniformly higher level of entitlement for contributors represent a solution to this 70-year problem? The big question for this kind of solution is whether it can ever be made impervious to two important dynamics that have undermined the current regime.

The first challenge is the question of what should count as a 'contribution'. A contributory welfare system is inevitably a two-tier system, and that requires a line to be drawn separating those who are and are not entitled to the more generous level of support. Some may want a more inclusive system that takes a broad definition of contribution for reasons of social solidarity. For advocates of broad system, those deemed to have contributed should include people

65 Ibid., 32.

with caring responsibilities, patchy work histories, and low-earners working short hours.

As Hills has documented, a trend in this direction has been evident for decades: "when governments of the left have been in power, arguments in favour of inclusion have been predominant, […] and contribution conditions have been softened to "credit in" people with low earnings or interrupted work histories."[66] This determination to make a contributory system inclusive is echoed by Bell and Gaffney in their call for those on low-earnings to be 'credited in', giving them access to contributory entitlements.

Yet inclusive social insurance systems are vulnerable precisely because they re-introduce the free-rider problem. It may be entirely justifiable to include those with caring responsibilities on grounds of the valuable social contribution they make. But those who count as contributors only on a broad definition are nonetheless beneficiaries of *financial* redistribution from others who make a financial contribution. That fact tends to undermine a basic principle of insurance on which sustainable contributory welfare must be built: that it cannot involve a systematic redistribution without net contributors wanting to leave the scheme. The greater the level of redistribution, the more politically vulnerable it is to residualisation.

The second vulnerability of a flat-rate contributory JSA top-up stems from the relationship between what different citizens pay in, and what they can expect to get out of the system. While Beveridge effectively proposed a flat-rate contributory entitlement, this was, at the time, matched by a flat rate insurance premium. Under that model, the only thing that differentiated what one person could expect to get out of the scheme compared to

66 John Hills, "Inclusion or Insurance? National Insurance and the future of the contributory principle', (ESRC Research Centre for Analysis of Social Exclusion, 2003), 11.

another was their relative likelihood of needing to claim. To the extent that unemployment risks were similar for all workers, one person's expected net contribution was similar to another's, hence the scheme could be broadly described as 'actuarially fair'.

Today, by contrast, National Insurance contributions are income-related and unemployment risks are more polarised than they were in 1948. In this context, a contributions-based top-up would inevitably have a strongly redistributive element to it. For that reason it is likely to be subject to the same trends that have eroded unemployment benefits for the past 40 years. This is an example of the second challenge for a contributory system: the need to relate what people pay in to a contributory system and what they can reasonably expect to get out.

What's in it for me?

In any viable private insurance scheme, there must be a very close relationship between what premium people pay and the value of the claims they might expect to make. Social security systems are more than market-based insurance schemes, in that they also reflect people's desire for a degree of social solidarity. This means there is some tolerance of a less 'actuarially fair' relationship than there would be in, say, car insurance.

Nevertheless, there is a limit to that tolerance, and any politically stable social insurance system must therefore broadly relate payments in to expected payments out. Analytically, the goal of redistribution is distinct from that of insurance. If policymakers want to achieve the two goals they may be better-off deploying two separate policy instruments to achieve them, rather than one that seeks to fudge the distinction. Actuarially 'unfair' public insurance systems may take longer to collapse than private ones, but collapse in time they will. A flat-rate top-up will therefore struggle to achieve the stability necessary for contributory welfare.

But if a flat-rate contributory top-up fails the actuarial fairness test, what kind of system would pass it? Here the continental European experience is instructive. Broadly speaking Continental insurance systems have remained part of the political consensus and replacement rates are consequently substantially higher than those in the UK. The key difference, as Jochen Classen has pointed out, is that continental schemes involve earnings-related entitlements, matching earnings-related contribution.[67]

Bismarckian regimes, such as the German Unemployment Benefit set workers' contributions as a percentage of their income and define claimants' entitlement as a percentage of prior earnings. In the case of Germany, contributions amount to 3% of gross income, up to a ceiling. Net income replacement rates are 60% for a single person, or 67% for a person with children, up to a maximum. Insurance-based Unemployment Benefit is available to workers for up to the first 12 months, hence replacement rates are much higher than the UK's, and comparable to other OECD countries, during the initial phase of unemployment.[68] In other words, unlike in the UK, there is a *proportionate* relationship between what individuals pay in and can expect to get out of the scheme.

Indeed, other continental regimes go even further towards binding those in the middle of the income distribution into the insurance system. Denmark is an example of the Ghent model of unemployment insurance – state-backed voluntary insurance schemes, typically administered by unions. Denmark's voluntary Unemployment Insurance involves a flat-rate premium combined with earnings-related entitlements for claimants, up to a ceiling.

67 Jochen Clasen, "Social insurance and the contributory principle: a paradox in contemporary British social policy", Social Policy and Administration, 35:6 (2001), 641–57.

68 OECD, "Benefits and wages: policies", www.oecd.org/els/benefitsandwagespolicies.htm.

This has two important effects. First, the insurance becomes more valuable as one's income rises: the monthly contribution is uniform, while the 90 per cent replacement rate makes benefit entitlement higher for those with higher salaries (up to a maximum of around £2,000 per month).[69] Second, the voluntary nature of the scheme, combined with a significant flat-rate premium, means that low-paid workers – those who face the biggest risk of unemployment – are effectively priced out of the scheme. This is evident in the vastly differing Unemployment Insurance coverage rates between low-paid and better-paid workers in Denmark.[70] Both of these dynamics mean that participants are confident that the insurance premium reflects their likely benefit from the scheme, a fact that is reflected in high coverage rates.

The UK's flat-rate subsistence system, by contrast, provides "a much weaker incentive structure for contributors to be involved in matters of social insurance."[71] Whatever the specifics, the usual contributory structure elsewhere involves a combination of more generous, time-limited insurance, followed by lower means-tested social assistance. Indeed, what remains of the UK's contributory unemployment benefit is unusual in the OECD in offering a uniform amount that is paid at the same rate as the means-tested benefits level. This is an important part of the explanation for the UK's meagre relative entitlement levels. A uniform benefit level inevitably means lowest common denominator entitlements.

Continental models of unemployment insurance show that it is indeed possible to have a more generous contributory system of welfare, and one that is politically stable (although both Denmark's and Germany's systems have seen substantial recent reform, as

69 Ibid.

70 Tor Eriksson and Jingkun Li, "Restructuring meets flexicurity: housekeeping work in Danish hotels" in *Low wage work in Denmark*, ed. Niels Westergaard-Nielsen (New York: Russell Sage Foundation, 2008), 197.

71 Classen, "Social insurance and the contributory principle: a paradox in contemporary British social policy", 651.

discussed below). But key to their enduring political legitimacy is that such systems tend to relate entitlements to contributions: they are very clearly mechanisms for insurance rather than redistribution. As such, these contributory systems tend to exclude the lowest-paid or those with patchy work histories.

Figure 3.1: Illustrating how contributions relate to entitlements in four different systems

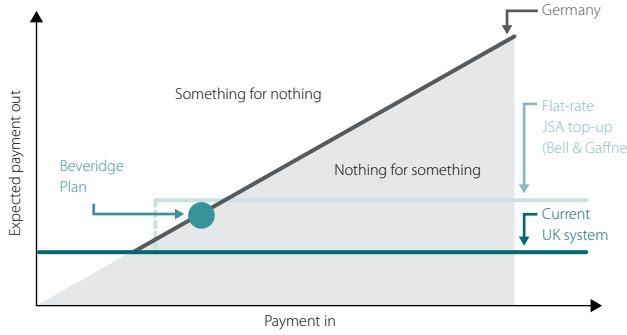


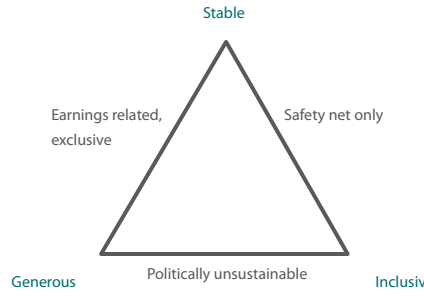
Figure 3.1 illustrates the relationship between contributions (rising as we move along the x-axis) and entitlements (rising as we move up the y-axis) in stylized representations of four different systems: the current UK system; the one Beveridge intended; the flat-rate JSA top-up idea; and the German Unemployment Benefit scheme. In the UK system, for example, contributions rise with one's income, but the entitlement to contributory JSA is fixed at £71.70 per week. Any other unemployment-related benefits that one might be entitled to, such as Child Tax Credit and Housing Benefit, are also offered at a flat-rate, regardless of past contribution. This is illustrated by a horizontal line, indicating that a person's entitlement does not increase no matter what their level of contribution may have been. The system envisaged by Beveridge involved a more generous entitlement of a fixed sum, paid for by contributions that were also fixed, rather than proportionate to income as they subsequently became. Hence Beveridge's plan is represented by

the green dot on the diagram. The German system, by contrast, offers a close relationship between contributions and entitlements, hence the scheme can be represented as following the 45-degree line on the diagram.

History suggests that, as with a private insurance scheme, social security systems are likely to be more resilient the closer they are to the 45-degree line relating contributions to entitlements. If a system offers people who pay in a lot very little in return, it will lie to the right of the 45-degree line in the 'nothing for something' zone, shaded grey in the diagram. And to the extent that it offers support to those who pay in very little, it will lie to the left of the 45-degree line, in the 'something for nothing' zone. If large proportions of the population are far away from the 45-degree line, the system will be politically unstable.

So in thinking about how to structure a social security system for the unemployed, policymakers have three variables to consider: the generosity of the scheme, its inclusivity and its political sustainability. In weighing up the options, policymakers face a social security 'trilemma' (see Figure 3.2). Any system one might try to design can be inclusive and politically stable, but it will be a uniformly ungenerous safety net system only, as the UK system currently has become. Alternatively, it can be generous and stable, as in the Dutch or German examples, but it will not be inclusive, its generosity reserved for middle and higher earners. Finally we can opt for a system that seeks to be both inclusive and generous, and hence highly redistributive. But that regime will ultimately prove politically unstable owing to the weakness of the system's legitimacy.

Figure 3.2: The unemployment benefit 'trilemma'



Key: Policy priority | System outcome

The first two conditions for a more generous and economically effective unemployment support system are therefore the exclusion of people who represent 'bad' employment risks, and a much closer relationship between contributions and replacement income. Creating such a link is a necessary condition for a politically saleable model. But it is also insufficient, as recent experience in other countries demonstrates.

Moral hazard: policing the system

While the contributory welfare regimes of Continental Europe have been more politically resilient to the kind of residualisation seen in the UK, they have not gone unreformed. So what has been the driving force for reform and what does it tell us about the design of a sustainable contributory system?

As discussed in the second essay in this series, unemployment support needs to tread a fine line between the perils of giving people insufficient time to seek appropriate work and allowing a comfortable existence, at the expense of other contributors, to reduce their efforts to seek work. The first of these problems is what Chetty refers to as the 'liquidity' problem: a situation where an unemployed person does not have the resources to finance continued job search even though longer search might result in a

more productive job match.[72] The second is the familiar problem of moral hazard, by which generous entitlement benefits reduce work search activity.

Introducing an earnings-related insurance scheme in the UK would tackle the existing liquidity constraints for middle and higher skilled workers. But it would also risk introducing moral hazard, as a life on benefits would become significantly more attractive than it is on today's meagre rates. That the current system is inefficiently stingy does not alter the fact that the weakened work incentives of a more generous regime need to be controlled. Any politically viable contributory system would need to address this issue.

Recent reforms in Germany and Denmark have sought to do just that, in response to concerns that generous contributory entitlements for the long-term unemployed were creating structural problems in the labour market.[73] Apart from the financial consequences for contributors and the direct loss of productive workers from the workforce, allowing people to spend years out of the workforce causes their skills to deteriorate, damaging productivity.

The 2005 Hartz reforms in Germany cut entitlement to unemployment insurance very substantially for the long-term unemployed. These took a large bite out of replacement rates, while retaining the generosity of entitlement for claims of up to one year. The result was a significant reduction in long-term unemployment.[74] Complementary reforms set out to improve the quality and intensity of work search assistance and requirements for both long- and short-term unemployed people. These

72 Raj Chetty, "Moral Hazard vs Liquidity and Optimal Unemployment Insurance", 1.

73 Lena Jacobi and Jochen Kluve, "Before and after the Hartz Reforms: the performance of active labour market policy in Germany", Discussion paper number 2100 (Bonn: IZA, 2006), 6, http://ftp.iza.org/dp2100.pdf.

74 Tom Krebs and Martin Scheffel, "Macroeconomic evaluation of labour market reform in Germany" (IMF: 2013), 10, www.imf.org/external/pubs/ft/wp/2013/wp1342.pdf.

changes were widely assessed to have helped increase out-flow from unemployment.[75]

Similar changes have been afoot in Denmark, combining reduced generosity of benefits for the long-term unemployed and more intensive activation policies. Maximum unemployment benefit claim durations have been progressively whittled away from seven years, two decades ago, to four by 1998.[76] In the wake of the 2008 recession, the maximum claim was cut to two years, and activation strategies have been intensified in order to get people back to work much more quickly.

Given the prevalence of long-term unemployment in Denmark and Germany prior to these reforms, concerns about moral hazard appear to have been very valid.[77] Unsurprisingly, then, political sustainability has required that time limits be put on the generous entitlements, and new steps have been taken to facilitate effective job search for all. The current UK system, by contrast, has rather the opposite problem. It uses low benefit levels from day one to encourage immediate re-entry into work for all. Nevertheless, any more generous earnings-related contributory system here would have to reflect the logic of the German and Danish reforms when it comes to long-term unemployment.

But moral hazard is not the only problem that needs to be avoided in the design of a welfare system. As explored in the second essay in this series, cutting benefit rates and increasing sanctions can raise off-flow rates from unemployment, but this is

75 Rene Fahr and Uwe Sunde, "Did the Hartz reforms speed-up job creation? A macro-evaluation using empirical matching functions", Discussion paper 2470, (Bonn,: IZA: 2006), 22, www.iab.de/UserFiles/File/downloads/gradab/Dokumente%20Stephan/fahr%20sunde.pdf.

76 Jochen Clasen and Daniel Clegg, "Beyond activation: Reforming European unemployment protection systems in post-industrial labour markets", *European Societies*, 8:4 (2006), 535, www.sps.ed.ac.uk/__data/assets/pdf_file/0015/9015/REUS_A_200154_O.pdf.

77 Liz Alderman, "Why Denmark is shrinking its social safety net", *Economix*, August 16, 2010, http://economix.blogs.nytimes.com/2010/08/16/why-denmark-is-shrinking-its-social-safety-net/.

not an unalloyed good for an efficiently functioning labour market. From an economic efficiency perspective, the appropriate level of 'stick' depends on whether a resulting fall in unemployment stems primarily from minimising moral hazard (a positive development) or from excessively restricting people's search time (a unhelpful development). Given the substantial generosity of the previous system for the long-term unemployed in Germany and Denmark, it seems likely that moral hazard was a significant problem. The UK, by contrast, is likely to have the opposite problem.

Striking the right balance would ideally be a matter of empirics. But institutional structures have a huge impact on decisions about the appropriate generosity and longevity of unemployment insurance entitlement, biasing it in one way or other according to extraneous factors. Designing a politically stable unemployment insurance system therefore requires a fourth design hurdle to be overcome.

Keeping the bean-counters out

In any area of life, the time between when a commitment is made and when it is honoured leaves open the possibility of default. Contractual relationships are intended to prevent this kind of 'time inconsistency' problem. But public policy is more vulnerable. Policymakers, making sequential optimal decisions, often exercise their discretion to renege on earlier commitments – often made by their predecessors, whose decisions they feel no moral or legal obligation to honour.[78] The history of unemployment insurance suggests that the same pre-commitment problem applies here under certain institutional designs.

When unemployment insurance entitlements are effectively subsidised by public taxation, the distinction between general taxation and contributions tends to dissolve. In the UK, Beveridge

78 Finn Kydland and Edward Prescott, "Rules rather than discretions: the inconsistency of optimal plans", *The Journal of Political Economy*, 85: 3 (1977).

himself argued that the importance of providing entitlements funded by insurance contributions lay in the fact that people wanted 'security not as charity but as a right'. As Rodney Lowe argues, "Insurance implied a contractual obligation on which, it was felt, government could not renege".[79] But renege it would, time after time, for working age recipients at least. And, as Lowe points out, for a government facing increasing demands for expenditure at the end of the Second World War, the concept of insurance provided a more acceptable form of taxation.[80] Yet the value of insurance benefits consistently slipped below the official poverty line represented by national assistance, which made means-tested top-ups the norm – and the contributory system something of a con.[81]

In later years, numerous efforts to revive the contributory basis of social security were made. But promises were issued and then reneged on by government's of all hues. In an effort to emulate the continental insurance systems, earnings-related contributions were brought in by the Conservative administration in 1958, in return for the promise of an earnings-related supplement to the flat-rate pension. That reform agenda also stretched to unemployment insurance, with the Earnings-Related Supplement introduced in 1966. This was justified on the grounds that a higher level of benefits for skilled workers with a good employment history would facilitate economic adjustment at a time of rapid structural change by reducing resistance to redundancy. As Mickelwright has argued, it could also have improved the efficiency of job matching, resulting in lower subsequent unemployment.[82] Barbara Castle sought to embed the continental approach with the introduction of the State Earnings-Related Pensions Scheme (SERPS) after 1975.

79 Rodney Lowe, *The welfare state in Britain since 1945* (London: Palgrave Macmillan, 1999), 132.

80 Ibid., 131.

81 Ibid., 147.

82 J. Micklewright, "The strange case of British earnings-related unemployment benefit", *Journal of Social Policy*, 18: 4 (1989), 527–547.

Over time, while the contributions remained, earnings-related insurance for both working age people and pensioners withered. Hills argues, with respect to SERPS, that by the time it was introduced, the prevalence of privately provided occupational pensions meant that the new scheme would never become the bedrock of provision for middle and higher earners "of a kind which has resulted in the strong political defence of continental social insurance schemes."[83]

But institutional factors seem even more central to the explanation for their demise. The 1958 reforms hastened their own destruction since they also formally broke Beveridge's intended link between contributions and estimated future liabilities for contributors. Instead, a pay-as-you-go scheme was formally embraced, in which contributions were to be no higher than to meet the current outlay.[84] As the distinction between National Insurance and the rest of the public finances dissolved, the earnings-related entitlements for working age and pensioners fell victim to the need to get wider public spending under control in the face of large budget deficits in the late 1970s. This was a goal explicitly pursued both by Labour in 1978[85] and by subsequent Conservative administrations, as the incoming Secretary of State, Patrick Jenkin, made clear to his civil servants in 1979.[86]

The result was substantial reductions in the generosity for working age entitlements, while contributions remained unchanged. Recent cost-saving examples include the reduction in the entitlement period for unemployment benefit from 12 months to six in 1996, and the restricting of the contributory Employment Support Allowance period to just one year in 2010, in response to the current fiscal crisis.

83 Hills, "Inclusion or Insurance?", 9.

84 Timmins, *The five giants,* 196.

85 Lowe, *The welfare state in Britain since 1945*, 321.

86 Timmins, *The five giants*, 373.

From the beginning, then, the fact that the National Insurance contributions were only nominally distinct from taxation meant that entitlements would be subject to the usual efforts by the Treasury to minimise costs and maximise revenues. Under these circumstances policy could never have been anything other than 'time inconsistent'. Promises to pay entitlements tomorrow in return for contributions today may have been sincerely advocated, but subsequent governments could not commit to leaving that deal untouched when the fiscal storm clouds gathered.

Had National Insurance been an independent fund with an actuarial relationship between contributions and entitlements, such a dynamic might have been avoided. Indeed, given the relative political saleability of spending on working age benefits and pensions, system stability would likely require that any unemployment insurance and pension funds also be distinct from one another.

The different experiences across Continental Europe in recent years show how important structural separation from the wider public finances is to a stable insurance system.[87] The origins of the Danish Ghent system of unemployment insurance was in union-provided private unemployment insurance. But the interwar experience of mass unemployment put an unbearable strain on the Ghent system, and tax-funded state support became inevitable.

Today Danish unemployment benefit entitlements are 83% tax funded. So it is no coincidence that the maximum entitlement level has been gradually reduced over time, such that the financial support provided by the means-tested system is now not far below that provided through the insurance scheme, at about 80% of the latter on average.[88] Although there is still a significant difference between the means-tested and insurance entitlement levels, then, it

87 Clasen and Clegg, "Beyond activation", 535.

88 Ibid., 535.

is clear that the exigencies of the public finances have led, over time, to the gradual residualisation of the Danish Ghent insurance system.

The crucial point to note here is that this has occurred *despite* the fact that the system robustly excludes non-contributors and, as a voluntary system, self-evidently retains the support of the vast majority of Danish workers. The driving force behind residualisation is therefore not adverse selection but an institutional reliance on the finance ministry.

By contrast, the German and French benefit systems, are characterised by both earnings-related entitlement and a higher degree of (and, in the French case, complete) institutional separation from government and the public finances. As Clasen and Clegg argue, this self-financing characteristic "acts as a powerful argument against political 'interference'".[89]

Consequently, it is hardly surprising that both the German and French unemployment insurance systems have proven much more resilient than either the British or Danish systems to this process of benefit 'homogenisation', by which the insurance-based system gradually becomes degraded to look increasingly like the means-tested one. Financial independence from the state is, it appears, a central condition for a lasting contributory system.

A WORKABLE SOLUTION?

So could a revival of the contributory insurance principle work? The conditions for a viable and sustainable contributory insurance scheme are clear from historical experience both here and abroad. In order to be resilient, the level of redistribution must be low and payments into the system will have some relationship to

89 Ibid., 543.

entitlements from it. The system must be effectively policed to allow and encourage work search time, while limiting moral hazard. And crucially the scheme's architecture must be financially independent of the exchequer.

A simple contribution-related top-up to JSA entitlement will not go with the grain of these immutable political and economic forces that shape the social security system. Such a solution will, before long, be another footnote in the history of the welfare state. As a jaundiced Permanent Secretary for Social Security observed in 1974, on hearing of Barbara Castle's plans for SERPS, "We are going to design a new plane from the models that have crashed on the runway".[90] His scepticism about the prospects for rejuvenating contributory welfare was prescient. With a further 40 years of experience, we now know which elements of design are the ones that led the contributory welfare plane to crash repeatedly – and how to make it fly.

Establishing an unemployment insurance scheme that meets these four challenges would be a hugely ambitious programme for any future government. And while the foregoing discussion has established the characteristics of the kind of regime that would have endured the social and industrial changes of the late twentieth century, whether it would be politically viable to introduce such a radically different scheme today is another question.

But even if a modern earnings-related unemployment insurance scheme could be kept distinct from the rest of the public finances, formidable challenges would remain. Given the toxic nature of the current debate, and widespread perception of a large moral hazard problem or 'dependency culture', the case would be hard to make. British social attitudes are far more individualistic than they were even a generation ago, hence any collective solution is likely

90 Timmins, *The five giants*, 345.

to be viewed with suspicion. This would be all the more so if the definition of contribution is drawn widely.

Moreover, despite the strong social and economic case for a more generous unemployment support system for skilled and experienced workers, the moral hazard problem remains a real efficiency cost. A politically saleable scheme would likely have to find a way to eliminate it. But the monitoring of jobseekers as part of activation policies, combined with a sanctions regime and time-limited entitlements, is a clumsy, costly and often demeaning regime. It is also one that is incompatible with the Beveridgean idea of insurance benefits 'as a right'. From a labour market efficiency perspective, generous entitlements will inevitably last too long for some workers and too short for others.

Not only is an insurance-based contributory welfare system a huge political challenge, but any viable scheme will result in a two-tier system involving a distinct, and less generous, means-tested safety-net. The insurance part of the scheme would cater for a good proportion – perhaps more than half – of those people currently claiming JSA. But the redistributive means-tested system would be the focus of just as much political attention as it is today. A better unemployment support system for the majority would therefore resolve the 'nothing for something' problem, but it would do much less to resolve the 'something for nothing' perception that lies at the heart of the crisis of legitimacy. Contributory welfare, in other words, can only be a partial solution to the political problems facing the current system.

CONCLUSION

In their own ways, the solutions on the table – from advocates of the orthodoxy and supporters of a contributory welfare scheme – implicitly acknowledge many of the underlying problems with

today's social security system. But the respective solutions are damaging and unworkable, or inadequate and incomplete.

The orthodox prescription is to merely minimise the problems of moral hazard by reducing the attractiveness of benefits and increasing external monitoring and sanctions. At best, this is a strategy to manage a problem, rather than address it directly. This lowest common denominator approach treats all claimants as though they are work-shy, creating a demeaning and meagre regime that does not oil the wheels of the labour market, and reduces the stock of human capital. By focusing on managing the downside risks, it fails to maximise many of the positive economic benefits that an effective system of working age welfare can bring.

The contributory welfare solution could solve the free-rider problem by requiring people to make contributions prior to receiving more generous benefits. But history shows that the conditions for a viable insurance system of this kind are demanding. Establishing such a scheme in the 21st Century would be a huge political undertaking. Moreover, any viable insurance regime would exclude those most reliant on means-tested redistribution. This would leave the most pressing legitimacy deficit still to resolve.

More than anything these solutions reflect a failure of imagination, both in the ways that the problems of working age welfare are defined, and in the technologies deployed to resolve them. In the final essay, we explore new solutions to the welfare challenge, offering the outline of a social security system that might once again command the confidence of the British people.

ESSAY 4: "FACEBOOK WELFARE"

Ian Mulheirn

> *"Compared with the contempt of mankind, all other evils are easily supported"*
>
> Adam Smith, The Theory of Moral Sentiments

INTRODUCTION

The welfare reform consensus of the past 30 years has run out of road. A focus on lowering replacement rates and strengthening sanctions has resulted in a system that is politically toxic and almost peerless in its deficiency for skilled and experienced workers. As we argued in earlier essays in this series, the consequences of such a system are economically harmful to the labour market. Its lowest common denominator nature means it undervalues the time it takes for skilled workers to find productive job matches.

Yet, as the last essay in this series explored, the usual forms of contributory welfare as collective insurance are fraught with problems. History and international experience demonstrate the huge challenges involved in designing a politically stable and economically effective insurance system of contributory welfare. And if a better collective support system could be created for skilled and experienced workers, it would come at the cost of exacerbating the problem of moral hazard that dogs any collective insurance system. Moreover, such a system would neither tackle the reality nor the perception of the 'something for nothing' problem for those on means-tested social assistance who have paid little or nothing in.

In this final essay we therefore seek to answer two questions:

- What would a more generous and economically efficient support system look like for skilled and experienced workers?
- How can the means-tested safety net be re-engineered to mitigate the problems of weak work incentives and demeaning monitoring regimes?

To answer these questions, we argue for two innovations in thinking about these well-worn problems. The first innovation is for policymakers to seek solutions that get inside people's heads, rather than relying exclusively or mainly on expensive, inefficient and demeaning external monitoring to tackle incentive problems. Policy should be designed to internalise the trade-off between the benefits of job search and its costs, rather than seeking to police it from without. As well as producing the instrumental benefit of more efficient outcomes, this principle also offers the intrinsic benefit of increasing personal freedom and empowering unemployed people to make their own decisions.

The second innovation is that in facilitating new forms of financial support, we must use the power of social connections to humanise social security, replacing the anonymity of today's transactional welfare with an element of compassionate obligation. It should seek to complement the heft of the state with the nuance of social relationships by fostering a sense of reciprocity.

These ideas take us to a radically different place from current policy: to a welfare system that creates better incentives for individuals; fosters reciprocity and the power of social groups; and uses the state as the backstop, rather than the sole counterparty when it comes to the financial risk of unemployment.

First we explore the case for individual Lifecycle Accounts as a concept, before going on to outline a workable model to

provide established workers with more financial security without damaging their work incentives. We then address the question of how the scheme can be used to tackle the politically toxic problem of 'something for nothing'. Finally we consider extensions to the Lifecycle Account approach that could make it a useful framework to accommodate the emerging welfare state of the 21st Century.

The ideas presented are unavoidably incomplete. The detailed proposals are only one manifestation of the general principles advocated, and there may be better ways to deploy those ideas in practice. Nevertheless, this final essay does identify genuinely new territory for policymakers to explore if they want to develop a social security system that is more supportive, more legitimate and more economically efficient than the one we have today.

PAYING FOR OTHERS, OR SAVING FOR ME?

A workable contributory scheme can be cheaper than the current one and supportive of the labour market, while also strengthening society and facilitating personal choice. These goals are only rendered hard to achieve by adherence to the uniform collective constraint of a national scheme as the only way for a society to manage risk fairly.

Faced with the social problem of unemployment, governments have for generations sought to provide a financial safety net. As we argued in the second essay in this series, such financial support also has an important role in subsidising job search, thereby improving workforce productivity. But as with any insurance policy, collective support also introduces the problem of moral hazard. As Stiglitz and Yun argue "Markets on their own did not provide unemployment insurance. Government had to step in to fill the lacuna. But government programs have been criticized for their

adverse effects on search."[91] This dichotomy is at the heart of the political problems of the welfare system today.

An entirely collective system – whether tax-funded or a stand-alone insurance scheme – therefore suffers from two related weaknesses. Among claimants, drawing on a collective pot funded by those in work, incentives to move back to work are weakened. Despite the benefits of the subsidy for job-search, a moral hazard problem exists for the unemployed person since the costs of insufficient urgency in work search – or being too picky about what job to accept – fall on others. For those in employment, meanwhile, the contributions or taxes paid to finance unemployment benefits reduce their progression incentives. That fact, combined perhaps with some myopia about the likelihood of their needing such a support system in future, reduces people's political support for paying into a pot that appears only to be distributed to 'other people' at any one point in time.

The result of a uniform collective system is either too little consumption smoothing (if benefits are meagre), or too much moral hazard (if benefits are generous). The UK, with its flat rate benefit system is at one end of that trade-off, doing little to help people smooth their lifetime consumption. But even here financial work incentive problems for the low paid are endemic.

The distribution of income at any point in time exacerbates the perception of a sharp distinction between the contributions of people who are and are not employed. Indeed a snapshot would suggest that this is the only type of redistribution that occurs: between those in work and those out of work. The political debate about 'strivers and scroungers' reflects this static picture.

91 Joseph Stiglitz and Jungyoll Yun, "Optimal provision of loans and insurance against unemployment from a lifetime perspective", NBER Working Paper No. 19064 (2013), www.nber.org/papers/w19064.

But income over longer periods is substantially more equal across the population than a snapshot would imply.[92] People who are unemployed at one point in time move back to work in another; high earners become low earners and vice versa. Over a whole lifetime, the ebb and flow of labour market fortunes tend to even themselves out, with differences between people becoming less pronounced. Most people have some experience of unemployment and other periods of higher earnings in the course of their lives. As a result, lifetime incomes tend to be substantially more equal than they seem on any given day.

These dynamics have been analysed by the IFS, who recently used data from 2006 to show that the Gini coefficient of earned income inequality for British households falls from 0.37 when measured on an annual basis to 0.24 over a lifetime.[93] This suggests a good deal of churn in the group of households that have no earned income at any one point in time.

It also implies that a great deal of welfare transfers can be thought of as a transfer from someone in employment to their future selves when unemployed, for example.

Every tax- or contributions-funded social security system involves a mixture of two types of financial transfer. There are elements of *inter*personal, redistributive, transfers: from those who, over time, have a better employment record and higher pay, to those who are less fortunate. But such schemes also involve substantial *intra*personal transfers: individuals pay in while they are employed and effectively draw down that money when they are not. In other words the expenditure associated with working age social security can be broken down into a redistributive element and a life-cycle element.

92 Stefan Fölster, Robert Gidehag, Mike Orszag and Dennis Snower, "Assessing welfare accounts", IZA Discussion paper No. 533 (2002), http://ftp.iza.org/dp533.pdf, 3.

93 Mike Brewer, Monica Costas Dias and Jonathan Shaw, "Lifetime inequality and redistribution", IFS Working Paper W12/23 (2012), www.ifs.org.uk/wps/wp1223.pdf, 18.

So what is the relative size of the redistributive and lifecycle parts of the current working age social security system? A common finding in the literature is that a large majority of taxes or contributions paid to fund welfare are ultimately paid back to the individual taxpayer at a later stage in their lives. Bovenberg et al estimate that around three quarters of the cash paid in to the Danish social insurance programmes is ultimately returned to contributors, leaving just one quarter being redistributed between people.[94] Evidence from other countries suggests similar proportions.[95]

One analysis from 1996 concluded that the proportion of lifecycle transfer in the UK benefits system was as much as 71%.[96] More recently, for unemployment-related benefits, the above evidence on lifetime income variability and recent DWP analysis showing a large proportion of JSA claimants with little if any past history of claims, suggests that there remains a high proportion of lifecycle transfers in the UK.

Despite the fact that most transfers end up being lifecycle ones, doing this collectively introduces two damaging effects. First, it makes the welfare system look more redistributive (*between* people) than it really is over the long run, making the system politically vulnerable. Second it introduces significant moral hazard incentive problems.

This type of work therefore suggests that, in theory, a significant part of the welfare system could be individualised. Doing so, it is argued, could eliminate the moral hazard problems of collective insurance without any negative distributional consequences.

94 A. Lans Bovenberg, Martin Ino Hansen and Peter Birch Sørensen, "Individual savings accounts for social insurance: rationale and alternative designs", *International tax public finance* (2007), http://arno.uvt.nl/show.cgi?fid=68840

95 Fölster et al, "Assessing welfare accounts"

96 Jane Falkingham and Ann Harding, "Poverty alleviation versus social insurance systems: a comparison of lifetime redistribution", NATSEM discussion Paper no.12 (1996), www.natsem.canberra.edu.au/storage/dp12.pdf, 30.

Individualisation would offer improvements to both the equity and efficiency of the welfare system, improving the public finances.

It should be possible for many individuals to smooth their own lifetime income, saving during periods of employment and drawing down on those savings while unemployed. Of course, this could happen with or without government action. However, financial asset holdings (excluding housing and pension wealth) are remarkably low for most of the population, particularly younger people. Among 25 to 34-year-olds in 2008–10, 62% have financial wealth of less than £5,000, with 45% having less than £500.[97] In the 35 to 44 age group 53% have less than £5,000, less than a fifth of median full-time earnings in 2010.[98] The majority of workers below the age of 45 have minimal or negative liquid savings to draw upon in unemployment. Unable to borrow in the event of unemployment, many of these people would be credit constrained. And as Raj Chetty's work for the United States has shown (see Essay 2), such financial constraints reduce search behaviour below the optimal level.[99]

The parallels with pensions policy are clear. There is a strong public interest in better management of longevity risk, and while that risk is privately manageable (if people save sufficiently and industry charges are reasonable), it is widely thought to be poorly managed (pensions saving is too low). Similarly, unemployment risk is manageable for most people who experience it, but low levels of precautionary saving mean that it is not currently well managed. As in pensions policy, there is a role for government in providing a backstop of support. But, also as with pensions, helping people to manage labour market risk better need not mean managing it *for* them by expanding existing mechanisms for collective insurance.

97 Office for National Statistics, "Wealth in Great Britain" (London: ONS, 2012), Chapter 3, 26.

98 Office for National Statistics, "2010 Annual Survey of Hours and Earnings" (London: ONS, 2010).

99 Raj Chetty, "Moral Hazard vs Liquidity and Optimal Unemployment Insurance", 1.

TACKLING NOTHING FOR SOMETHING?

As described above, the primary economic case for individualised welfare accounts – which we will refer to as Lifecycle Accounts – is that the approach resolves the incentive problems of insurance systems. This yields efficiency benefits primarily by internalising the trade-off between the pros and cons of longer work search. Individuals effectively share unemployment risk with their future selves, eliminating – or at least reducing – the need for external policing that is at the heart of all collective systems. For the Exchequer the benefits of such a reform could be substantial: higher tax revenues from employment and lower expenditure on the vast activation infrastructure of Jobcentre Plus.

But this economic advantage is not the only benefit of the lifecycle account model. It also makes use of insights from Prospect theory. As Kahneman and Tversky showed in their seminal work on this topic, people are far more responsive to the prospect of losing something than they are to that of gaining something – the so-called 'endowment effect'.[100] Watching one's personal account balance dwindle is therefore likely to be a very real spur to action under a lifecycle account system. The essential insight is that simply by reframing the individual's choices in this way, policy can encourage individuals to strive for better outcomes for both themselves and taxpayers.

100 Daniel Kahneman and Amos Tversky, "Prospect Theory: An analysis of decision under risk", *Econometrica*, XLVII (1979), 263–291.

A number of models have been proposed for unemployment accounts of one sort or another. Proponents range from Nobel Laureate Joseph Stiglitz to the Danish Economic Council. Stiglitz and Yun propose a model of integrated Unemployment Insurance, which brings together pensions saving and precautionary saving to maintain standards of living when people become unemployed.[101] In effect people can access their pensions savings to fund higher unemployment benefit replacement rates.

Other models, such as the individual welfare account proposed by Bovenberg et al, and modelled using Danish data, operate along similar lines.[102] Brown et al have proposed a mandatory unemployment account under which savings of lower-paid workers are subsidised by a tax on the savings of other account holders in order to retain the redistributive character of the collective system.[103] Paul Gregg has proposed the idea of a Lifetime Investment Savings Account (LISA), a savings account that would be available to people for a variety of purposes, including unemployment.[104]

The IPPR's Graeme Cooke has proposed a rather different model based on a credit facility – a National Salary Insurance scheme – for unemployed people, by which people can top-up their income while unemployed and repay the money on an income-contingent basis on re-entering employment. Box 4.1 below briefly outlines the scheme.

101 Joseph Stiglitz and Jungyoll Yun, "Integration of unemployment insurance with retirement insurance", NBER working paper 9199 (2002), www.nber.org/papers/w9199.pdf, 2.

102 A. Lans Bovenberg, Martin Ino Hansen and Peter Birch Sørensen, "Efficient Redistribution of Lifetime Income through Welfare Accounts" Fiscal Studies, 33:1 (2012).

103 Alessio Brown, Michael Orszag and Dennis Snower, "Unemployment accounts and employment incentives", IZA discussion paper no.2105 (2006), http://ftp.iza.org/dp2105.pdf.

104 Paul Gregg, "The potential for a flexible lifetime savings account", in *Liberation welfare* ed. Paul Gregg and Graeme Cooke (London: Demos, 2010), 178.

Box 4.1: National Salary Insurance

The problem of credit constraints for people who have been unable to build up a positive account balance, is a common objection to lifecycle account proposals. One solution to that problem is for the state to provide a loan facility offering higher levels of financial support, to be repaid when claimants re-enter work. Graeme Cooke of the IPPR has advocated this approach, with detailed proposals about how such a scheme might work.[105]

The National Salary Insurance scheme would be open to any unemployed person who qualifies for contributory JSA, entitling them to up to 70% of their previous gross earnings, for up to six months of unemployment. Money borrowed through the scheme would then be repaid on an income contingent basis once the individual returns to work.

The idea of a loan scheme of this sort has similarities to Stiglitz and Yun's 2002 proposal that people should be able to borrow against future pensions saving while unemployed.

Economically this idea plays a very similar role to a lifecycle account in respect of unemployment, with the difference that people who have not yet been able to build up a positive account balance would still be able to draw financial support. This would have the advantage of extending support to a wider group of the workforce. But it would also have the disadvantage that the state would be assuming financial risk, since some loans would never be repaid. That risk would not arise were people only to draw on accrued savings.

Practical examples of these kinds of accounts or loan facilities for working age people are harder to find. There are many examples of tax-incentivised savings plans around the world, aimed primarily at encouraging retirement savings (see Box 4.2). In this way they respond to the moral hazard problem of pensions saving but do

105 Graeme Cooke, National Salary Insurance (London: IPPR, 2011)

nothing to solve the similar, arguably more pressing, problems in the working age population. However, the author is not aware of any example of accounts that are specifically designed to be drawn down upon during periods of unemployment.[106]

Box 4.2: Personal accounts that don't help the unemployed

- **Singaporean Central Provident Fund** accounts are a mandatory saving scheme initially designed to internalise the costs of retirement. Since the CPF's introduction in colonial Singapore in 1955, the scheme has been expanded and accounts can now be used to pay for education, housing or medical insurance, subject to their retaining sufficient funds to provide a minimum retirement income. For all but the over-55s, however, CPF money cannot be drawn down to replace income during a spell of unemployment.
- In the **United States, 401(k)** retirement savings accounts are intended only to build up a pension pot. These savings are accessible for people of working age, but those withdrawing funds during a spell of unemployment will typically have to pay tax on the distribution and face a 10% penalty charge, making draw-downs prohibitively expensive. Where 401(k) plans do resemble an unemployment account is that some plans allow savers to borrow from their pot provided the money is repaid with interest on re-entering employment. Loans that are not repaid are treated as withdrawals.
- The **Dutch Life Course Savings Scheme** allows tax-free saving for employees in order to fund periods of leave during employment. At the end of one's working life, any accumulated credits are transferred to one's pension entitlement. Money cannot be drawn down to supplement income during unemployment and is therefore fundamentally different from an unemployment account.

106 In the US it is possible for some savers to borrow a limited amount from their 401(k) in cases of hardship.

- From October 2012, the **UK's National Employment Savings Trust** will see millions of people automatically enrolled into a pension saving scheme. While participation is not mandatory – the innovation here is that employees have to actively opt out if they don't want to participate – funds accumulated are subject to the usual pension rules in being inaccessible to savers until the age of 55.

To a large degree, this reflects a big practical problem with the idea of individualising benefit transfers in countries that already have established collective benefit schemes. If people with healthy account balances are to rely on an income drawn down from their account, while those without savings receive means-tested benefits, account-holders face a large effective tax rate on their savings. Each pound saved would reduce benefit entitlement by, perhaps, 65 pence if unemployment income from the account were to count against one's Universal Credit entitlement.

If contributions to a lifecycle account were voluntary, few would sign up on these terms. If contributions were mandatory, the punitive rate of effective taxation on savings would make the scheme politically unworkable. For these reasons, despite the largely lifecycle nature of the transfers involved in the benefits system, the idea of individualising large swathes of it is impractical unless one is to advocate reducing the level of redistribution for those who have no savings to fall back on.

A WORKABLE LIFECYCLE ACCOUNT

Nevertheless, there is a huge opportunity to introduce an individualised support system that sits *on top* of the existing welfare state. This is particularly the case in the UK since, unlike most other countries in the OECD, our flat-rate benefits system offers little support, relative to working income, to anyone but those on the lowest earnings.

For these reasons, we advocate a Lifecycle Account which people would use to top-up entitlement to means-tested benefits during periods of unemployment. Our proposed personal contributory support system would primarily complement, rather than replace, the existing welfare system. Its aim would be to facilitate and encourage self-funded and time-limited additional support for people experiencing unemployment.

The examples of existing personal accounts for retirement savings, outlined above, hint at this idea of a broader lifecycle account system that would help people to smooth their consumption during their working lives. Indeed, the UK is currently putting in place the foundations of such a system. Auto enrolment into pensions saving began last October, defaulting all employees (by 2018) into saving 8% of their gross earnings each year. Early evidence suggests that the enrolment rate is proving higher than anticipated, with nine people out of ten choosing to remain in the scheme.[107] Of course these high rates are likely to decline as employees of smaller firms enter the scheme and contribution rates rise towards the target 8% level.

Allowing savers early access to their pension saving has often been promoted as a means to encourage people to save more for retirement. And the limited available evidence suggests that it would have this effect. Analysing early access options under US 401K plans, the Pensions Policy Institute concluded that allowing a similar approach here could result in marginal improvements in pensions saving rates and levels.[108]

107 Josephine Cumbo, "Appetite grows for UK pensions saving", *The Financial Times*, May 7, 2013, www.ft.com/cms/s/0/5d3fb862-b6f8-11e2-a249-00144feabdc0.html#axzz2V4Ywo1p5.

108 Daniela Silcock, Sean James and Adam Steventon, *Would allowing early access to pension savings increase retirement incomes?* (London: Pensions Policy Institute, 2008), 27.

But raising pension saving is not the only important policy goal. First there is an intrinsic benefit to helping people smooth their lifetime consumption during working age, particularly when precautionary saving levels are low and will likely be lowered further by the introduction of auto-enrolment. Second, doing so can also improve the functioning of the labour market and incentives on jobseekers.

When these important policy goals are taken into account, the case for a more flexible and integrated approach to lifecycle saving becomes compelling. Nor would the commonly cited risks of early access – allowing pension savings to be funnelled into over-consumption of housing or used to pay off debtors – be a concern in our proposed Lifecycle Account model.[109] Details of the proposed form of the system are set out in Box 4.3, below.

109 HM Treasury, *Early access to pension savings: a summary of responses to the call for evidence* (London: HM Treasury, 2011), 8.

Box 4.3: How could a Lifecycle Account work?

- From age 16, all citizens would open their own Lifecycle Account, nominating three guarantors – friends or family with positive Lifecycle Account balances who agree to take on the role.
- Building on the framework for pension auto enrolment currently being phased in, individuals (and their employers) would contribute a proportion of their gross income into the account each month, benefiting from tax relief, as with the current pensions framework. In line with the OECD's recommendations for maximising the coverage of pension saving, a portion of the planned 8% voluntary contribution rate for auto enrolment would be made compulsory under the Lifecycle Account, with the remainder continuing to be voluntary.[110]
- On becoming unemployed, Lifecycle Account holders would automatically draw a monthly income top-up from their Account.
- Income from the account would be sufficient to top-up entitlement to means-tested Universal Credit to the point where total household income would be 80% of previous gross income for a family with children and 70% for a childless individual or couple. For very low earners, or modest earners with very high housing or child-related entitlements the top-up would be small since means-tested benefits already provide relatively high replacement rates for these groups.
- Income top-ups from the Lifecycle Account would be limited to a maximum duration of six months – in line with current contributory JSA entitlement. This would enable middle-income workers time to search for appropriate employment while also protecting their retirement savings against significant depletion. After the 'contributory entitlement period' had elapsed the claimant would cease to receive a top-up and would rely only on means-tested benefits.
- Money drawn down from the account would be repaid through subsequent earnings. Failure to do so over a given period would result in guarantors having to repay a proportion of the

110 OECD, *Pensions outlook 2012* (Paris: OECD, 2012), 115.

outstanding amount, giving them a direct interest in their friend's work search activities, even after the initial six month contributory period is complete.

- Cash from the account would not be accessible for other reasons such as funding a deposit to buy property or to pay off existing debts due to the perverse consequences that would result (see below for a discussion of viable extensions to the idea).
- Lifecycle Account balances would then be used to purchase annuities on retirement, to be paid in addition to the basic state pension.

The fiscal implications of the scheme result from the extent of additional saving – over and above the effect of auto-enrolment – that would be likely to occur as a result of allowing early access to the savings. For people who currently save into a pension, or for those who consider their chances of unemployment to be low, the costs are likely to be negligible. For people who are not currently making provision for retirement, any element of compulsion in the proposed scheme will involve tax relief costs to the extent that they also increase pensions coverage. This is, of course, a goal that all governments are keen to achieve for its own sake.

On the other hand, the improvement in work incentives (see below) would have positive fiscal consequences, raising tax revenue and lowering benefit spending. The net effects of these influences is uncertain, but it is reasonable to imagine that the scheme would be a net benefit for Exchequer.

What would be the consequences of the Lifecycle Account for retirement savings levels? Box 4.4 shows that, even the 'worst case' scenario for a typical person's pensions savings, the implications of allowing draw-downs for working age unemployment support are small. Only a modest increase in the typical person's contribution rate would be required to leave them with an unchanged income in retirement.

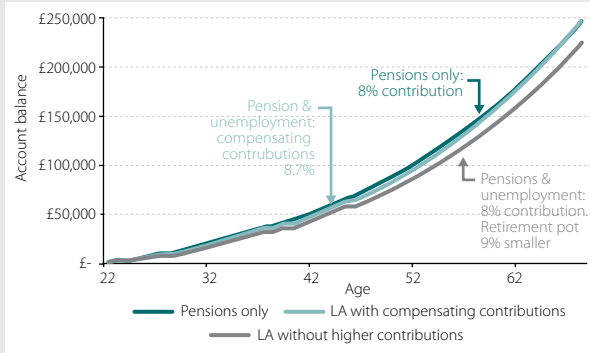
Box 4.4: Higher contributions or lower retirement income?

The chart below shows a Lifecycle Account balance over time for a highly stylized case of a citizen who earns median income throughout their life, and experiences five separate six-month unemployment spells during their working life (see assumptions below). In keeping with *Example 1* from Box 4.5, the amount draw-down from this person's Lifecycle Account is equivalent to £1,262 (in 2012 money) for each six-month period of unemployment. Five such periods would mean cumulative withdrawals over the person's lifetime of around £5,000 in respect of unemployment.

The chart illustrates that, under plausible assumptions, the allowing people access to long term savings during unemployment will only have a marginal impact on pension savings at the point of retirement – reducing it by around 9% – in the case where the person saves no more than they would have done under pensions auto-enrolment. If this person were to raise their contributions such that they were to be no worse off in retirement, the extra contribution rate would be minimal, at around 0.7% of gross income above the auto-enrolment threshold.

Clearly these figures are sensitive to the assumptions used, but this basic analysis serves to demonstrate that, given the scale of financial responsibilities faced by people of working age, the early access offered by Lifecycle Accounts represents valuable unemployment insurance at a minimal cost in terms of retirement income.

Chart 4.1: Evolution of a typical Lifecycle Account balance



Assumptions

We take the 2012 median full-time annual earnings level of £26,300, and assume that this grows by two per cent per year in real terms. With the long-term natural rate of unemployment estimated by the Office of Budget Responsibility to be 5.5 per cent, it is reasonable to assume that this person spends approximately two and a half years of their 49-year working life unemployed, between the ages of 19 and 68. Of course, in reality there is likely to be a small group of people who spend a much higher proportion of their working life looking for work. But for a typical person this assumption seems realistic. Lifecycle Account balances are assumed to grow at three per cent each year in real terms, in line with the (now defunct) Financial Services Authority's most recent projections of future investment returns. No management charges are assumed (although this makes little difference to the point being illustrated).

FACEBOOK WELFARE: IMPROVING INCENTIVES WITH SOCIAL CONNECTIONS

The key advantage of the Lifecycle Account is that in topping-up basic means-tested entitlements, an unemployed person can afford to search for the *right* job match. She understands her options and constraints better than the distant state ever could. And in drawing on her own resources, she also faces strong incentives to search harder than would be the case in a collective scheme offering the same level of financial support.

But although the Account would allow income top-ups without damaging incentives, a claimant's continued partial reliance on state benefits means that moral hazard would remain a problem if the Account was nothing more than a savings vehicle.

Nevertheless, our proposal contains a new element designed to limit these negative consequences by drawing upon social connections. On their own, individual accounts of the kind considered

in the literature can be effective in aligning economic incentives and psychological influences on behaviour. But sociological influences on behaviour are also hugely powerful. Stoker and Moseley point out that "people are influenced by their immediate social networks, which are themselves based on reciprocity and mutuality".[111] Avner Offer refers to this phenomenon as the 'economy of regard' in which social "interaction is driven by the grant and pursuit of regard".[112] These non-market but *external* stimuli can be brought to bear on the problems we have highlighted.

People's friends and family have far greater capacity than any government agency to perform three roles that are all essential to maximising the effectiveness of the benefit system in all its aims:

- Friends and family can more readily **observe** the unemployed person's efforts to seek work than a government agency or any private insurance provider;
- Friends and family are in a far better position to **help** them in their work search than are anonymous employment advisors; and
- The **censure or disapproval** of friends and family are far stronger motivators than the threat of financial sanctions by the Jobcentre.

In other words, close social connections can be drawn upon to augment the financial support of the state with a compassionate obligation on claimants. This is the essence of what might be called 'Facebook Welfare' – harnessing the power of real social networks to improve the welfare system and the operation of the labour market. In recent weeks Nobel laureate Joseph Stiglitz has published work that draws on very similar thinking about the

111 Gerry Stoker and Alice Moseley, Motivation, *Behaviour and the Microfoundations of Public Services* (London: 2020 Public Services Trust, 2010), 18.

112 Avner Offer, The Challenge of Affluence (Oxford: 2005), 77.

potential for augmenting public support with social knowledge. In a paper published in May 2013, Stiglitz and Yun argue that:

> *"[A] non-market group (such as family, village etc.) that has a superior monitoring ability (to that of government or markets) and a sense of peer pressure among its members, can be used to improve welfare"*

Informational advantages mean that leveraging the power of social relationships into the social security system could improve it dramatically. Indeed this approach has much in common with the principles behind microfinance group loans in the developing world. Drawing upon social relationships offers the only cost effective way to mitigate the incentive problems of financial support without simply making the system less generous for everyone.

So in practical terms how could friends and family help to improve the incentives in this new system for supporting unemployed people? There are a number of ways one could envisage achieving such involvement. But the common idea has similarities with some of the principles at play in other areas of public service reform, particularly payment by results: to devolve some of the financial accountability for achieving 'good' outcomes away from government and towards people who have better information and greater scope to influence those outcomes for mutual benefit.

Specifically, in this case, all Lifecycle Account holders would have to identify three guarantors. These guarantors – chosen from among friends or family who have positive account balances themselves – would effectively underwrite a proportion of the money drawn down from their friend's Lifecycle Account as unemployment support. In the event that the money borrowed was not repaid to the account, guarantors would be liable for a proportion of the outstanding funds. This would give guarantors a direct stake in their friend finding work and paying back the

money that had been withdrawn. Where an individual is unable to recruit three guarantors, they would not be eligible for a Lifecycle Account and the accessible tax-incentivised savings it offers. Box 4.5 presents a worked example of the Lifecycle Account for two specimen households on middle incomes.

Box 4.5: The Lifecycle Account in Practice

Example 1: Single parent John

John is a 32 year-old single parent, living in Kent, earning the full-time median income of £26,300,[113] with one child. The family's net income is £423.57 per week, composed of net income after income tax and National Insurance contributions, and Child Benefit of £20.30 per week. John has identified three guarantors from among his friends and family and therefore has a Lifecycle Account. Into the Account he contributes 8% of gross income above £5,668 per year (the pensions auto-enrolment threshold). Having paid into his Lifecycle Account for ten years, John's account has £22,000 in it.

On being made redundant from his job, John is entitled to £135.61 per week in Local Housing Allowance for a two-bedroom house in his area. He also receives Child Tax Credit of £62.72 and Child Benefit of £20.30 per week, as well as Jobseeker's Allowance at £71.70. The family's net income out of work is therefore £290.33 per week: 68.5% of its net income when John was working.

With his Lifecycle Account, John's weekly income while out of work is automatically topped-up to 80% of the working level, for the first six months of his unemployment. This involves drawing down £48.53 per week, taking the family's weekly net income out of work to £338.86. If John does not find work within six months, his top-up payments will stop, leaving the family to rely only on means-tested support. At that point he will have drawn down a total of £1,262 from his Lifecycle Account, leaving a balance of £20,738.

On getting a new job, John would have to repay the money borrowed from his Account – despite his overall balance not having

113 Annual Survey of Hours and Earnings, 2012 Provisional Results (ONS: 2012).

gone into the red – before being eligible for further Lifecycle Account top-ups in the event of future unemployment. At a contribution rate of 8%, it would take John around nine months to repay on his old salary

Each of John's three guarantors is liable for 10% of the money he borrows from his Account. If John does not begin repaying the money within two years of becoming unemployed, his guarantors therefore face a penalty of £126, to be taken from their own Accounts. This small but significant financial liability acts to strengthen John's accountability to his guarantors for efforts to find work.

Example 2: Lab technician Jane

Jane is a recently qualified lab technician, earning £20,000 per year on a temporary contract. She lives on the Wirral and is single. Her net income is £315.83 per week after tax and National Insurance contributions. Jane has identified three guarantors and contributes 8% of her gross income into her Lifecycle Account, above £5,668 per year.

On becoming unemployed at the end of her contract, Jane is entitled to £86.54 per week in Local Housing Allowance for a one-bed flat on the Wirral. She also receives Jobseeker's Allowance at £71.70. Her net income out of work is therefore £158.24 per week: 50.1% of her net income in work.

Since Jane has only been working for six months, she only has a balance of £573 in her Lifecycle Account, which nevertheless automatically tops-up her income to 70% of the net working income level, for the first six months of her unemployment spell. This involves drawing down £62.84 per week, taking her weekly net income during the initial phase of unemployment to £221.08. Jane does not find work within six months, so her top-up payments stop, leaving her reliant on the means-tested minimum. By this time, Jane's Lifecycle Account balance has been reduced by £1634, taking her balance into the red at - £1061. If Jane finds a job at her old salary shortly afterwards, and repays the borrowed money at a contribution rate of 8%, she will have repaid the full £1634 drawn down after seventeen months, bringing her Account back to its original balance of £573.

If Jane remains out of work and is unable to make repayments within two years, her guarantors will each be liable for 10% of the money borrowed from her Account. In this example, Jane's guarantors would be liable for £163 each, to be taken from their Lifecycle Accounts.

Since there would be tight limits on the sums that could be withdrawn, for the vast majority of guarantors, the financial liability would be negligible. The overwhelming majority of people would return to work and repay. And the downside of that liability would be more than outweighed by the advantages of greater flexibility of tax-relieved savings that Accounts would offer for guarantors themselves. But Facebook Welfare is potentially even more powerful in tackling the 'something for nothing' problem that is at the heart of the current crisis of legitimacy.

FACEBOOK WELFARE: TACKLING 'SOMETHING FOR NOTHING'

Lifecycle Accounts therefore offer a neat resolution the fact that millions of people with solid work histories feel that the adequacy of support does not reflect their contribution. By allowing them access to tax-relieved savings to manage a broader range of risks than simply old age, the state can help people to smooth their lifetime incomes more effectively, and potentially improve the public finances in the process. But that begs the question of what can be done to tackle the legitimacy problem for claimants who have not 'paid in' – people with nothing in their Lifecycle Account.

Those on the fringes of the labour market, or on very low pay, will find it difficult to build up savings sufficient to top-up their benefits income for the full six months. Meanwhile young people, as new entrants to the labour market, and the group most frequently hit by spells of worklessness, would also have little or nothing in the way of savings to draw upon. They are, in other words, credit constrained. Some will go on to have a solid subsequent work history. Others may end up persistently unemployed.

Here, the role of guarantors allows both types of people to *borrow* from their Account – with negative balances financed by

government – to top-up their income without the state assuming excessive risk (see Example 2, Box 4.5). With the liability for some of that greater generosity falling on the recipient's guarantors, Facebook Welfare strengthens claimants' obligation to society by diversifying it. Not only do they have to meet the job-search requirements of the Jobcentre if they are to remain eligible for support, they are now also accountable to some of the people who know them best.

This dynamic would help to foster a powerful reciprocal relationship. Guarantors would be made more inclined to want to help their unemployed friend. And despite the minimal level of exposure involved, recipients' sense of obligation to their guarantors is likely to be far more influential on their subsequent actions than any state-imposed direction. Depending on the extent of the financial liability borne by guarantors, it may be possible to reduce the need for expensive state monitoring and sanctions, instead putting social relationships at the leading edge of the benefits system.

The central insight is that in a conventional welfare system there is a direct trade-off between the generosity of benefits and work incentives, while under Facebook Welfare it is by increasing the generosity of support that we can strengthen work incentives by mobilising social resources and allowing the state to step back.

This draws on the same principles as those that underpin group lending in microfinance schemes for the developing world. There, joint liability serves as collateral for a loan, and the structure of the incentives created cuts down the need for expensive monitoring by lenders, or in this case government.

This would fundamentally change the shape of the welfare state, away from the impersonal form of 'tidy' welfare described in the second essay in this series. Rather than the state displacing private relationships of financial support, it would actively

seek to strengthen them, by distributing a notional financial liability. That liability would be small enough to avoid putting significant pressure on those relationships, but large enough that the claimant's actions be of some concern to the guarantor.

LIFECYCLE ACCOUNTS AND THE 21ST CENTURY WELFARE STATE

In essence, a Lifecycle Account would bring together saving for unemployment and old age within the same vehicle. But other changes going on in the welfare state suggest a wider role for the concept.

Human capital investments such as tertiary education and childcare provision are increasingly imposing costs on private individuals. The benefits of these investments primarily accrue to private individuals, and the long-term prognosis for the public finances makes it unlikely that these service will ever become fully publicly financed, nor in most cases should they. But these goods also have substantial positive 'externalities' – spillover benefits to the rest of society. The state therefore has an important role in encouraging and facilitating such investments.

The 21st Century welfare state is emerging to be one in which government uses its balance sheet and taxation infrastructure to facilitate the private provision of some goods that involve a mixture of both a public and private benefit. Human capital investments are the most obvious – and costly – examples of such goals. Lifecycle Accounts can be thought of as a way to simplify and rationalise the overlapping strands of the new approach. Box 4.6 outlines how Lifecycle Accounts could be extended to play a much wider role in the 21st Century welfare state.

Box 4.6: Wider applications for the Lifecycle Account

Over the course of the late 20th Century, much has changed in the welfare state and the society in which it operates. One important trend has been towards greater volatility in household consumption over the lifecycle. Four social and policy developments are particularly relevant.

- With the expansion of Higher Education, the state has retrenched from funding undergraduate degrees in full, leaving graduates to pick up a large proportion of the cost.
- Businesses have stepped back from offering defined benefit schemes that leave them on the hook for rising longevity.
- The erosion of the relative value of benefits, and dismantling of contributory benefits, leave individuals increasingly reliant on themselves in the face of periods of unemployment or sickness.
- With the feminisation of the workforce and rising childcare costs, many working families have to pay substantial childcare fees.

As these risks have been pushed from government and employers onto families and individuals, two things have happened. First, and most obviously, the costs have been individualised. Second, where one once relied on the state or one's employer to fund these services, the cost to the individual was effectively spread over a lifetime in the form of tax, NI, or private pension contributions. These vehicles for consumption smoothing have largely been eroded at the collective level due, to fiscal pressures, and are slowly being rebuilt at the individual level in a fragmented way.[114]

Two examples illustrate steps in this direction. Pensions auto-enrolment, launched last October, is designed to encourage people to take responsibility for funding their own retirement by saving 8% of their gross income for retirement. Meanwhile, in student finance, student loans allow graduates to repay their tuition fees over a number of years.

114 Nigel Keohane, Jam tomorrow: the next 20 years of savings policy (London: Social Market Foundation, 2012).

These reforms may individually have merit, but in combination they will inevitably reduce people's capacity to save privately for risks such as unemployment or the costs of childcare. Will graduates facing 9% deductions from their salary (over an income threshold of £21,000 per year) be content to pay a further 8% into a pension at the same time as saving for a house deposit, having children and putting money aside in case they lose their job? Employment risks and the childcare bill therefore add substantially to the pressures on family finances at certain points in the lifecycle. Many may simply be unable to managethose employment risks well. A balkanised approach to policymaking is, therefore, making it harder for people to smooth consumption over their lifecycle. Policy can and should be doing the opposite.

A Lifecycle Account could be designed to help people protect themselves against unemployment, while also integrating these other elements of the 'personal welfare state' to help people manage large lifecycle outlays.

This broader Lifecycle Account could act as a credit facility for investment in human capital. Borrowing would be permitted for HE tuition fees or childcare costs, in return for a higher level of mandatory contributions. Guarantors would not be necessary for these forms of investment. Contributions would pay down debt in the Account, and seamlessly begin to build a combined pension and unemployment insurance pot thereafter.

Higher mandatory Account contributions would be required for people who have used their Account to finance Further or Higher Education, for example. It may also be necessary to have an employment condition on those who want to access their Account to fund childcare. But higher contributions would present an additional opportunity to use people's natural inertia to switch seamlessly from paying off education debts into saving for retirement and unemployment. The by-product of such a scheme would be better levels of saving for retirement.

So Lifecycle Accounts would enhance welfare by helping people better to manage big financial risks and investments over their lifetime. As a result, the scheme would enhance personal choice and freedom, giving people far more flexibility to invest in themselves – their job search and their education – and their children, while also making them take responsibility for the trade-offs involved in each area.

CONCLUSION

Lifecycle Accounts offer contributory welfare for the 21st Century. As the welfare state has evolved, collectivism has receded in many areas. Given the diversity of risks that different people face in the modern world, it will be very hard to rebuild these collective systems. In any case, doing so would inevitably bring with it unintended incentive problems that are, in most cases, avoidable.

But as collective forms of support have receded, many of the risks and big lifetime outlays have increased. Wider society has a profound interest in seeing that those private risks are managed well, to maximise people's potential and to prevent them falling on the support of the state. The insight of this essay has been that while the state may no longer seek collectively to insure people against unemployment, or fund their further education, it can and should facilitate the better private management of these costs for the benefit of all.

Instead of seeking to displace private support systems, the state can seek to work with them by harnessing the power of social connections to support people better financially, while also improving the incentives they face.

Putting all of these elements together we have proposed a 'Facebook Welfare' system of Lifecycle Accounts. This is a system that can tackle the crisis of legitimacy in the welfare state at

both ends of the problem. Contributors can be sure that they will get adequate financial support reflecting their contribution. Meanwhile those who have yet to contribute are made primarily accountable to those around them, rather than the impersonal state, to repay the support that society has afforded them. The result is a system that aligns personal incentives, psychological insights, and social networks behind a fairer and more efficient system of unemployment protection.

Almost inevitably, there will be practical problems to be overcome in implementing such a scheme. But the alternative is bleak: today's minimal collective system that distorts incentives and yet provides meagre levels of support for all; an increasingly negative and demeaning regime of external monitoring by government agencies; and a perpetual political row about 'benefit scroungers'. We can create a better welfare state. But it will require open minds and new thinking, which this report aims to begin.

Seventy years ago, the Beveridge Report was launched to popular acclaim. People queued around the block to pick up their copy of the seminal blockbuster. Yet over the intervening 70 years, the descent from Beveridge has been total. Public attitudes have hardened towards unemployed people, and the political parties now compete to sound tough on 'scroungers'.

This series of essays explores this crisis of legitimacy in working age welfare. It examines the policy options for what to do about financial support for the unemployed. Should it be more generous? Should it be less generous? Or should we somehow revive the central plank of Beveridge's 1942 proposals: benefits claimed as a right based on past contribution? The essays conclude with radical proposals for an entirely new direction of reform, putting social networks at the heart of the welfare system.

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